Nichols Patrick
CPE, INCORPORATED
Experts in Tax Training

CURRENT FEDERAL TAX DEVELOPMENTS

CURRENT FEDERAL TAX DEVELOPMENTS

EDWARD K. ZOLLARS, CPA

THE MATERIAL IN THIS MANUAL IS DESIGNED FOR, AND INTENDED TO SERVE AS AN AID TO, CONTINUING PROFESSIONAL EDUCATION OF CPAs AND OTHERS IN SEMINAR PRESENTATIONS. DUE TO THE CERTAINTY OF CONTINUOUS CURRENT DEVELOPMENTS, THIS MATERIAL IS NOT APPROPRIATE TO SERVE AS THE SOLE AUTHORITY FOR ANY OPINION OR POSITION. IT MUST BE SUPPLEMENTED FOR SUCH PURPOSES BY REFERENCE TO OTHER CURRENT AUTHORITATIVE MATERIALS.

NICHOLS PATRICK CPE, INC.
973 W. Liberty St., Ste. A
Hubbard, OH 44425
www.npcpe.net

ELECTRONIC MANUAL ENHANCEMENTS

When using the electronic version of this manual please notice the bookmark feature. This appears in the left menu column. Move to the second symbol that looks like a piece of ribbon and left click once.

You will see a listing of each module in the bookmarks. Left clicking on the module you want to view takes you directly to that learning module.

Also next to each module title when you see a plus sign left click on the plus sign and it will show you the content of the module. Left clicking allows you to move directly to the information you wish to view in that module.

Also, the table of contents in the document is interactive to assist you in moving freely through the manual to locate needed information.

Please take advantage of these features for quick movement from one area of the manual to another.

Questions? E-mail barbara@npcpe.net.

Thank you.

Nichols Patrick
CPE, INCORPORATED
Experts in Tax Training

COURSE OFFERINGS 2015-2016

Accounting & Auditing: Comprehensive Annual Review
Accounting Methods: 174 Options for Federal Income Tax Reporting
Advanced Tax Practice
Advanced Tax Update: for Experienced Practitioners
AMT
Assisting the Survivors: A CPA's Role in the Decedent's Estate
Business and Industry Tax Update
Corporate Taxation: Subchapter C for C Corporations and S Corporations
Church & Minister Taxation
Construction Contractors: Special Tax and Accounting Considerations
CPA Succession Planning
Current Federal Tax Developments
Depreciation, Repairs and Fixed Assets: Tax Considerations
Effective Communication Skills Workshop
Estate and Gift Taxation: Planning and Compliance
Ethics and Quality Control in Tax Practice
Family and Succession Planning for the Business Owner
Fringe Benefits: 2015/2016
HSAs, HRAs, and FSAs
Income Taxation of Trusts and Estates: Planning and Compliance
Introduction to U.S. Taxation of International Transactions
Introduction to Partnership Taxation
Investment Taxation: Medicare Tax and Beyond
IRS Practice and Procedure: Audits, Appeals, Assessment, Settlement, and Collection
Medical Finances: Enhancing Your Value to a Medical Practice
Multi-State Taxation of Businesses
Navigating Divorce: Tax & Litigation Issues
Oil & Gas Accounting 101

Your state society is scheduling now for 2015. Let them know your preferences.

Oil & Gas Taxation: Advanced Issues and Update
Oil & Gas Tax Landowner & Investor
Oil & Gas Taxation: Nuts & Bolts
Partnership and LLC Taxation: Advanced Issues
Partnership/S Corporation Basis and Distribution Issues
Pass-Through Entities: Advanced Tax Issues
Planning for Medical and Dental Practices
Preparing Complex 1040s
Preparing Form 1041: Understanding the Basics
Preparing Form 1065: Understanding the Basics
Preparing Form 1120S: Understanding the Basics
Red Flag Issues: Areas the IRS Attacks in Examination
S Corporations: Advanced Issues
Social Security Benefits: Advising Clients
Streamlined Tax Staff Training - Individual
Streamlined Tax Staff Training - Business
Streamlined Tax Staff Training - Complex Return Issues
Streamlined Tax Staff Training - Tax Research and Quality Control Issues
Tax Aspects of Bankruptcy: All Need Not Be Lost
Taxation of Real Estate Partnerships
Tax-Exempt Organizations: Advanced Planning Issues
Tax-Exempt Organizations: Basic Operating Issues
Tax Planning With $ense
Tax Preparer to Trusted Advisor
Tax Research: Sources, Methods, and Documentation
Tax Smart Financial Planning for Individuals Under 40
Tax Staff Training - Individual
Tax Staff Training - Business
Tax Staff Training - Advance Issues

For onsite presentations phone 1.800.874.2749

CURRENT FEDERAL TAX DEVELOPMENTS

TABLE OF CONTENTS

Page

(12/13/14 ekz)

expert assistance is required, the services of a competent professional person should be sought." -- from a declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.

LEGISLATIVE DEVELOPMENTS AND ITEMS IMPACTING TAX YEAR 2014

It's an even numbered year so, yet again, we are facing a high level of uncertainty regarding what provisions of the tax law will turn out to be actually effective for 2014. The same problem advisers faced in 2010 and 2012 returns in 2014, as a large number of "temporary" tax provisions expired at the end of 2013.

This time around the extenders are complicated a bit by continuing discussion of tackling tax reform instead of just "kicking the can down the road." However, the early resignation of Senate Finance Committee Chairman Max Baucus to take an ambassadorship may have greatly complicated the mechanics of getting fundamental reform through the Congress. In fact, some commentators believe that Max Baucus may have decided to seek an early out from his position after concluding that fundamental tax reform (an issue he has had a continuing interest in) simply wasn't going to happen before his scheduled departure at the end of 2014.

Representative Dave Camp, chair of the House Ways and Means Committee, remains in Congress and is also interested in fundamental tax reform. However, so far there has been little interest expressed generally in Congress aside from the two chairs, and their "road trips" in 2013 did not appear to have yet created a public outcry for such a program.

Most commentators believe the most likely resolution of the matter will be the same as in 2010 and 2012—the lame duck Congress will, as one of its final acts, pass an extenders package following the election. However, it is clearly possible the Congress will do nothing since agreements for the package have been increasingly more difficult to obtain. The 2012 extender package did not actually pass the Congress until January 1, 2013 and did so only after a number of false starts.

While the current package of extenders does not have the hot button political issue that was the expiration of the (once extended) 2001 tax cuts, the provisions in the Bill are costly to enact (part of the reason why they remain as "temporary" provisions) and budget issues could make it difficult to craft a package that can pass muster in both houses.

As well, the results of the 2014 mid-term elections likely will also have significant impact in this area. The pending switch of control of the Senate to the Republicans (subject to the caveat that full control in the Senate demands more seats than the Republicans have or the Democrats had—60 seats) could lead to a decision to delay action until next year—or could inspire the Democrats to cut a deal while they still control the Senate agenda.

At the time this manual was written the House had overwhelmingly passed both an extender bill and new tax-preferred savings account for certain disabled individuals, with the two bills combined into one. The Senate had not yet taken action on the bill and the nature of Congress is such that nothing should be taken for granted, but for now these bills appears to be the most likely next step for Congress. Thus these bills will be discussed after the discussion of the expiring provisions.

Thus flexibility will be a key goal for actions taken in 2013. Clients should understand that they may need to take actions late in the year or have to be able to see into the future to decide what, if anything, the next Congress might do in terms of retroactive tax relief after they are seated in January.

As well, depending on how long it takes Congress to decide on what provisions (if any) to extend, the beginning of the filing season may again be impacted. In *PPC's Five Minute Tax Briefing* for October 22, 2014, IRS Commissioner John Koskinen was quoted as stating that if Congress doesn't finalize the tax laws by the end of November (a date the Congress failed to meet the last two times the extenders have been up for renewal) that there will likely be delays in the start of the filing season. Similarly, even when the season is started it seems likely there will again be delays in the processing of certain forms, delaying the date for acceptance of many electronically filed returns.

Expiring Tax Provisions

The Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2014-2024* (JCX-1-14), January 10, 2014 provides a list of expired and expiring tax provisions.

The first list is of those provisions that are already officially no longer part of the Internal Revenue Code. While there are taxpayers for whom each of these provisions would be a key loss, we have identified in italics those provisions what will likely most strongly impact the largest number of clients of CPAs in public practice.

IRC PROVISIONS WHICH EXPIRED AT THE END OF 2013

IRC Section	Provision
25C(g)	Credit for certain nonbusiness energy property
30C(g)(2)	Alternative fuel vehicle refueling property (non-hydrogen refueling property)
30D(g)	Credit for two- or three-wheeled plug-in electric vehicles
35(a)	Credit for health insurance costs of eligible individuals
40(b)(6)(H)	Second generation biofuel producer credit (formerly cellulosic biofuel producer credit)
Incentives for biodiesel and renewable diesel:	
40A	Income tax credits for biodiesel fuel, biodiesel used to produce a qualified mixture, and small agri-biodiesel producers
40A	Income tax credits for renewable diesel fuel and renewable diesel used to produce a qualified mixture
6426(c)(6) & 6427(e)(6)(B)	Excise tax credits and outlay payments for biodiesel fuel mixtures
6426(c)(6) & 6427(e)(6)(B)	Excise tax credits and outlay payments for renewable diesel fuel mixtures
41(h)(1)(B)	***Tax credit for research and experimentation expenses***
42(b)(2)	Determination of low-income housing credit rate for credit allocations with respect to nonfederally subsidized buildings
45(d) & 48(a)(5)	Beginning-of-construction date for renewable power facilities eligible to claim the electricity production credit or investment credit in lieu of the production credit
42(g)(1) & 142(d)	Treatment of military basic housing allowances for low-income housing credit and for qualified residential rental project exempt facility bonds
45(e)(10)(A)(i)	Credit for production of Indian coal
45A(f)	Indian employment tax credit
45D(f)(1)	New markets tax credit
45G(f)	Credit for certain expenditures for maintaining railroad tracks
45L(g)	Credit for construction of new energy efficient homes

IRC Section	Provision
45M(b)	Credit for energy efficient appliances
45N	Mine rescue team training credit
45P	Employer wage credit for activated military reservists
51(c)(4)	***Work opportunity tax credit***
54E(c)(1)	Qualified zone academy bonds: allocation of bond limitation
62(a)(2)(D)	***Deduction for certain expenses of elementary and secondary school teachers***
108(a)(1)(E)	Discharge of indebtedness on principal residence excluded from gross income of individuals
132(f)	Parity for exclusion from income for employer-provided mass transit and parking benefits
142(d)	Treatment of military basic housing allowances under low-income housing credit
163(h)(3)	Premiums for mortgage insurance deductible as interest that is qualified residence interest
164(b)(5)	***Deduction for State and local general sales taxes***
168(e)(3)(A)	Three-year depreciation for race horses two years old or younger
168(e)(3)(E)(iv), (v), (ix), 168(e)(7)(A)(i) & (e)(8)	***15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements***
168(i)(15) & 168(e)(3)(C)(ii)	Seven-year recovery period for motorsports entertainment complexes
168(j)(8)	Accelerated depreciation for business property on an Indian reservation
168(k)(1),(2) & 460(c)(6)(B)	***Additional first-year depreciation for 50 percent of basis of qualified property (December 31, 2015 for certain longer-lived and transportation property)***
168(k)(4))	Election to accelerate AMT credits in lieu of additional first-year depreciation (December 31, 2015 for certain longer-lived and transportation property)
168(l)	Special depreciation allowance for second generation biofuel plant property
170(b)(1)(E) & 170(b)(2)(B)	Special rules for contributions of capital gain real property made for conservation purposes
170(e)(3)(C)	Enhanced charitable deduction for contributions of food inventory
179(b)(1), (2) & 179(f)	***Increase in expensing to $500,000/$2,000,000 and expansion of definition of section 179 property***
179C(c)(1)	Placed-in-service date for partial expensing of certain refinery property (The commencement-of-construction date for self-constructed property is December 31, 2009)
179D(h)	Energy efficient commercial buildings deduction
179E(a)	Election to expense advanced mine safety equipment
181(f)	Special expensing rules for certain film and television productions
199(d)(8)	Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico
222(e)	***Deduction for qualified tuition and related expenses***
408(d)(8)	***Tax-free distributions from individual retirement plans for charitable purposes***

IRC Section	Provision
451(i)	Special rule for sales or dispositions to implement Federal Energy Regulatory Commission (“FERC”) or State electric restructuring policy
512(b)(13)(E)	Modification of tax treatment of certain payments to controlling exempt organizations
871(k)(1)(C), (2)(C), & 881(e)(1)(A), (2)	Treatment of certain dividends of regulated investment companies (“RICs”)
897(h)(4)	RIC qualified investment entity treatmentunder the Foreign Investment in Real Property Tax Act (“FIRPTA”)
953(e)(10) & 954(h)(9)	Exceptions under subpart F for active financing income
954(c)(6)	Look-through treatment of payments between related controlled foreign corporations under the foreign personal holding company rules
1033	Extension of replacement period for nonrecognition of gain for areas damaged by 2008 Midwestern severe storms, tornados and flooding (sec. 702 of Division C of Pub. L. No. 110-343)
1202(a)(4)	Special rules for qualified small business stock
1367(a)(2)	***Basis adjustment to stock of S corporations making charitable contributions of property***
1374(d)(7)	***Reduction in S corporation recognition period for built-in gains tax***
Empowerment zone tax incentives (The empowerment zone tax incentives may expire earlier than December 31, 2013 if a State or local government provided for an expiration date in the nomination of an empowerment zone, or the appropriate Secretary revokes an empowerment zone’s designation. The State or local government may, however, amend the nomination to provide for a new termination date.)	
1391(d)(1)(A)(i) & (h)(2)	Designation of an empowerment zone and of additional empowerment zones
1202(a)(2) & 1391(d)(1)(A)(i)	Increased exclusion of gain (attributable to periods through 12/31/18) on the sale of qualified business stock of an empowerment zone business
1394 & 1391(d)(1)(A)(i)	Empowerment zone tax-exempt bonds
1396 & 1391(d)(1)(A)(i)	Empowerment zone employment credit
1397A & 1391(d)(1)(A)(i)	Increased expensing under sec. 179
1397B & 1391(d)(1)(A)(i)	Nonrecognition of gain on rollover of empowerment zone investments
1400L(d)(2)(D)	New York Liberty Zone: tax-exempt bond financing
Incentives for alternative fuel and alternative fuel mixtures other than liquefied hydrogen (The related provisions for liquefied hydrogen fuel expire September 30, 2014)	
6426(d)(5) & 6427(e)(6)(C)	Excise tax credits and outlay payments for alternative fuel
6426(e)(3)	Excise tax credits for alternative fuel mixtures
7652(f)	Temporary increase in limit on cover over of rum excise tax revenues (from $10.50 to $13.25 per proof gallon) to Puerto Rico and the Virgin Islands

IRC Section	Provision
Sec. 119 of Pub. L. No. 109-432 as amended by sec. 756 of Pub. L. No. 111-312	American Samoa economic development credit

Astute observers will recall that the vast majority of these provisions are the same ones that had expired at the end of 2011, and were retroactively extended by the American Taxpayer Relief Act of 2012 that became law on January 3, 2013. Thus, it seems reasonable to suspect that some or all of those provisions might end up yet again being extended at some point this year.

One item deserves special note. The provisions that are expiring in §179 include the provision that allowed for a revocation of a §179 election after the due date for filing the return had passed (IRC §179(c)(2) as it existed prior to 1/1/14). In Reg. §1.179-5(c)(2)(i) the IRS expanded this provision to allow late elections to make the election as well as revoking an election. Revenue Procedure 2008-54 extended this treatment to taxpayers for any year through the last year under §179(c)(2) for revoking an S election.

With §172(c)(2) not being effective for years beginning on or after January 1, 2014, taxpayers would need to clearly designate any property that might be viewed as requiring capitalization under §263(a) as being part of a §179 election. If the taxpayer fails to do that, on exam an agent can force capitalization of such items even if the taxpayer has plenty of "unused" §179 amounts for the year in question and clearly could have elected that treatment.

If Congress does not extend the periods for which §179(c)(2) relief will be available, CPAs will need to advise clients regarding the need to take care that "questionable" items are covered either by making an explicit §179 election for the item or insuring that they make the Reg. §1.263(a)-1(f) "de minimis" election under the repair/capitalization regulations first effective in 2014 and comply with all of the requirements for that election (including the requirements for an explicit capitalization policy).

Although fewer in number, there are some other provisions that expire in later years. The JCT detailed the following items for the years indicated.

PROVISIONS EXPIRING IN 2014

IRC Section	Provision
30B(k)(1)	Alternative motor vehicle credit for qualified fuel cell motor vehicles
30C(g)(1)	Alternative fuel vehicle refueling property (hydrogen refueling property)
431(d)(1)(C)	Automatic amortization extension for multiemployer defined benefit pension plans
432	Additional funding rules for multiemployer defined benefit pension plans in endangered or critical status

PROVISIONS EXPIRING IN 2016

IRC Section	Provision
25D(g)	Credit for residential energy property
48(a)(2)(A)(i)(II)	Increased credit for business solar energy property

IRC Section	Provision
48(a)(3)(A)(ii)	Credit for hybrid solar lighting systems
48(a)(3)(A)(vii), 48(c)(4), and 48(c)(3)(A)(iv)	Energy credit for geothermal heat pump property, small wind property, and combined heat and power property
48(c)(1)(D) and (c)(2)(D)	Credit for business installation of qualified fuel cells and stationary microturbine power plants

PROVISIONS EXPIRING IN 2017

IRC Section	Provision
24(d)(4)	Child credit: reduce the earnings threshold from $10,000 to $3,000 for refundable portion of the credit
25A(i)	American opportunity tax credit
Earned Income Tax Credit	
32(b)(3)(A)	Credit percentage of 45 percent for three or more qualifying children
32(b)(3)(B)	Increase beginning and ending income levels for joint returns by $5,000 indexed after 2009

PROVISIONS EXPIRING IN 2020

IRC Section	Provision
45J(d)(1)(B)	Placed-in-service date for eligibility for the credit for production from certified advanced nuclear power facilities

PROVISIONS EXPIRING IN 2021

IRC Section	Provision
420(b)(5)	Transfer of excess pension assets to retiree health and life insurance accounts

Tax Increase Prevention Act of 2014

The House has passed the Tax Increase Prevention Act of 2014 which contains one year extensions for most of the provisions that expired at the end of 2013. The bill also contains a number of technical corrections to prior bills and, after passage, the House added the provisions in the Achieving a Better Life Experience (ABLE) Act of 2014 which created ABLE accounts to the law.

Included in the list of provisions that would get an additional year's lease on life for 2014 is the qualified home mortgage debt exclusion under §108, a provision that in the last round of extenders only received a single year extension, suggesting Congress might be looking to let the provision die.

As well, the §179 expensing limitation is returned to the $500,000 level and bonus depreciation is also retroactively extended through the end of 2014.

Some provisions also received some modifications in addition to the extension, but in most cases the bill amounted to a straightforward additional year added to the date the provision is set to leave the law. Unfortunately this means that we may be facing the same problem a year from now if the new Congress is unable to move quickly on a more permanent solution.

For now, here are the extended provisions and their new sunset dates.

Individual Tax Provisions

- Above the line deduction for the expenses of elementary and secondary school teachers under IRC §62(a)(2)(D) – extended through 2014

- Exclusion from gross income of the discharge of indebtedness of qualified principal residence obligations under IRC §108(a)(1)(E) – extended through 2014

- Parity for Employer Provided Mass Transit and Parking Benefits under §132(f)(2) – extended through 2014

- Treatment of Mortgage Insurance Premiums as Qualified Residence Interest under §163(h)(3)(E)(iv)(I) – extended through 2014

- Deduction for State and Local Sales in Lieu of State and Local Income Taxes under §164(b)(5)(I) – extended through 2014

- Contributions of Capital Gain Real Property Made for Conservation Easement Purposes under §170(b)(1)(E)(iv) – extended through 2014

- Above the Line Deduction for Qualified Tuition and Education Expenses – extended through 2014

- Tax Free Distributions from IRAs for Charitable Purposes - extended through 2014

Business Tax Provisions

- Research Credit under §41 – extended through 2014

- Temporary Minimum Low-Income Housing Tax Credit Rate for Non-Federally Subsidized Buildings under §42(b)(2)– extended through 2014

- Military Housing Allowance Exclusion for Determining Whether a Tenant in Certain Counties Is Low-Income under Section 3005 of the Housing Assistance Tax Act of 2008 – extended through 2014

- Indian Employment Tax Credit under §45A – extended through 2014

- New Markets Tax Credit under §45D – extended through 2014

- Railroad Tax Maintenance Credit under §45G – extended through 2014

- Mine Rescue Team Training Credit under §45N – extended through 2014

- Employer Wage Credit for Employees Who Are Active Duty Members of the Uniformed Services under §45P – extended through 2014

- Work Opportunity Tax Credit under §51 – extended through 2014

- Qualified Zone Academy Bonds under §54E – extended through 2014
- Classification of Certain Racehorses as 3-Year Property under §168(e)(3)(A) – extended through 2014
- 15-Year Straight-Line Recovery for Qualified Leasehold Improvements, Qualified Restaurant Buildings and Improvements and Qualified Retail Improvements under §168(e)(3)(E) – extended through 2014
- 7-Year Recovery Period for Motorsports Entertainment Complexes under §168(i)(15) – extended through 2014
- Accelerated Depreciation for Property on an Indian Reservation under §168(j) – extended through 2014
- Bonus Deprecation under IRC §168(k) – extended through 2014
- Enhanced Charitable Deduction for Contributions of Food Inventory under §170(e)(3)(C) – extended through 2014
- Increased Expensing Limitation and Treatment of Certain Real Property as Section 179 Property under §179(b)(1) – extended through 2014
- Election to Expense Mine Equipment under §179E – extended through 2014
- Special Expensing Rules for Certain Film and Television Projects under §181 – extended through 2014
- Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico under §199 – extended through 2014
- Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations under §512(b)(13)(E) – extended through 2014
- Treatment of Certain Dividends of Regulated Investment Companies (Mutual Funds) under §871(k) – extended through 2014
- RIC Qualified Investment Entity Treatment Under FIRPTA pursuant to §897(h)(4)(A) – extended through 2014
- Subpart F Exception for Active Financing Income under §953(e) – extended through 2014
- Extension of Look-Thru Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Personal Holding Company Rules under §954 – extended through 2014
- Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock – extended through 2014

- Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property under §1367 – extended through 2014

- Reduction in S-Corporation Recognition Period for Built-in Gains Tax under §1374 – extended through 2014

- Empowerment Zone Tax Incentives under §1391 – extended through 2014

- Temporary Increase in Limit on Cover Over of Rum Excise Taxes to Puerto Rico and the Virgin Islands under §7562 – extended through 2014

- American Samoa Economic Development Credit under Tax Relief and Health Care Act of 2006 – extended through 2014

Energy Tax Extenders

- Credit for Nonbusiness Energy Property under §25C – extended through 2014

- Second Generation Biofuel Producer Credit under §40 – extended through 2014

- Incentives for Biodiesel and Renewable Diesel under §40A – extended through 2014

- Production Credit for Indian Coal Facilities Placed in Service Before 2009 under §45 – extended through 2014

- Credits With Respect to Facilities Producing Energy From Certain Renewable Resources under §45 – extended through 2014

- Credit for Energy-Efficient New Homes under §45L – extended through 2014

- Special Allowance for Second Generation Biofuel Plant Property under §168(l)(2) – extended through 2014

- Energy Efficient Commercial Buildings Deduction under §179D – extended through 2014

- Special Rule for Sales or Dispositions to Implement FERC or State Electric Restructuring Policy for Qualified Electric Utilities under 451 – extended through 2014

- Excise Tax Credits Relating to Certain Fuels under 6426 – extended through 2014

Multi-Employer Defined Benefit Pension Plans

- Automatic Extension of Amortization Periods under §431 – extended through 2015

- Shortfall Funding Method and Endangered and Critical Rules under Pension Protection Act of 2006 – extended through 2015

Achieving a Better Life Experience (ABLE) Act of 2014

In addition to the extenders package, the House added on a new provision that was tagged onto the extenders bill under the "Achieving a Better Life Experience (ABLE) Act of 2014." The bill creates a new type of account (ABLE account) that may be established for eligible individuals.

Eligible individuals must be blind or severely disabled (determined under Social Security definitions) and must have become so before turning age 26. However, a person does not have to be receiving benefits under Supplemental Security Income (SSI) or Social Security Disability Insurance (DI) in order to qualify for the account, nor will qualifying for a §529A account mean the person is eligible for either of those benefits. [§529A(e)(1)(A)]

Generally, a qualified program established under §529A is exempt from current taxation, though it will still be potentially subject to the unrelated business income tax found at IRC §511 that generally applies to tax exempt charities, assuming it has UBIT income. [IRC §529A(a)]

To be a qualified program, the following requirements must be met:

- The program must be one established by a State, agency or instrumentality which:
    - Allows individuals to make contributions to the program for the benefit of an individual (referred to as an ABLE account)
    - The ABLE account is established to meet "qualified disability expenses" of the individual
    - No individual may have more than 1 such ABLE account
    - Such accounts can only be established for :
        - A resident of the State in question or
        - A resident of a contracting State
    - Which complies with all other requirements of §529A [§529A(b)(1)]
- Contributions must be limited as follows:
    - Only cash contributions may be made
    - For each year the total contributions may not exceed the gift tax exclusion under IRC §2503(c) for the year ($14,000 in 2014)
    - Any excess contributions may be returned before the due date of the return for that tax year [§529A(b)(2)]
- A separate accounting must be provided for each beneficiary. [§529(b)(3)]
- The program must provide safeguards that generally would prevent the contribution of excess aggregate amounts, based on limits established by the State. [§529A(b)(6)]

- Neither the contributor nor the beneficiary may direct the investments of the ABLE account [§529A(b)(4)]

- The ABLE account may not be pledged as security for a loan [§529A(b)(5)]

The tax treatment of distributions to the beneficiary is generally governed under the standard annuity rules of §72 except to the extent the distributions are used to pay qualified disability expenses. [IRC §529A(c)(1)(A)] Such excess payments will be subject to an additional 10% tax unless they are paid following the death of the beneficiary or are timely returns of overcontributions. [§529A(c)(3)]

In applying the annuity rules of §72 to determine the amount potentially taxable:

- All distributions made during the year shall be combined and treated as one (except as provided otherwise by Regulations the IRS may issue) and
- The value of the contract, income on the contract and investment in the contract shall be computed as of the end of the year (except as to be provided in Regulations the IRS may issue) [§529A(c)(1)(D)]

If total distributions for the year do not exceed the eligible individual's qualified disability expenses for the year, the entire distribution will be exempt from tax. If the distributions exceed that amount, the amount otherwise includable under the annuity rules will be reduced by an amount equal to the ratio of qualified disability expenses to total distributions. [§529(c)(1)(B)]

Qualified disability expenses are defined as any expenses related to the eligible individual's blindness or disability which are made for the benefit of an eligible individual who is the designated beneficiary. The law cites specific examples, which include:

- Education,
- Housing,
- Transportation,
- Employment training and support,
- Assistive technology and personal support services,
- Health,
- Prevention and wellness,
- Financial management and administrative services,
- Legal fees,
- Expenses for oversight and monitoring,
- Funeral and burial expenses,
- Other expenses

The expenses must meet the requirements of the (to be written in the future) regulations and consistent with the purposes of such ABLE accounts.

Amounts can be rolled tax free from one ABLE account to another. A distribution will qualify for tax free rollover if the amount of the distribution is paid into another ABLE account no later than 60 days after the distribution. The ABLE account must be for the benefit of the same eligible beneficiary or another eligible individual who is a member of the family of the original beneficiary. [§529A(c)(1)(C)(i)] However, if the transfer occurs within 12 months from the date of a previous transfer to a qualified ABLE program the beneficiary it will not qualify for tax free rollover treatment—so, like IRAs, there is a “once per 12 months” limit imposed. [§529A(c)(1)(C)(iii)]

Similarly, the beneficiary of the ABLE account can be changed during the year to another eligible individual who is a member of the family of the original beneficiary. [§529A(c)(1)(C)(ii)]

A “member of the family” means a brother, sister, stepbrother or stepsister. The same rules that apply for treating adopted children as having any of those relationships for purposes of determining dependents under §152 shall be used for this purpose as well. [§529A(e)(4)]

Special gift tax rules are provided for amounts paid into the ABLE program on behalf of the beneficiary. The gift will be treated as a completed gift of a present interest in the property and it will not be treated as a transfer excluded from gift treatment for payment of educational or medical expenses of the beneficiary under IRC §2503(e). [§529A(c)(2)(A)] Distributions from the ABLE account will not be treated as a taxable gift. [§529(c)(2)(B)]

A change in the beneficiary of an ABLE account will be potentially subject to both gift and generation skipping transfer taxes unless the new beneficiary is an eligible individual and a member of the family of the original beneficiary. [§529A(c)(2)(C)]

If more than ABLE account is established for the same individual, only the first account to be established for the eligible individual will be treated as an ABLE account. Therefore, none of the others will have tax free status for the income of the account. [§529(c)(4)]

The ABLE program will be required to report to the IRS and designated beneficiaries reports with respect to:

- Contributions
- Distributions
- Return of Excess Contributions
- Any other information the IRS may require [§529(d)(1)]

The trustee of the ABLE account will also notify the IRS upon the establishment of an ABLE account giving the name and state of residence of the designated beneficiary, as well as any other information the IRS may require. [§529(d)(3)]

Excess contributions to an ABLE account will be subject to the excess contributions tax on retirement accounts found at IRC §4973. [§4973(a)(6)] That tax is set at 6% per year on the remaining over-contribution to the account.

Each State will also be responsible for submitting monthly reports to the Social Security Administration statements on relevant distributions and account balances of ABLE accounts. [§529A(d)(4)]

States which do not establish an ABLE program may contract out the operation of such a program to another state that does administer such a program. [§529A(e)(7)]

When the beneficiary of an ABLE account dies, the funds in the ABLE account generally pass to the sponsoring State. However, the amount distributed to the state does not include:

- Outstanding payments due for any qualified disability expenses
- Amounts in the account in excess of total medical assistance paid for the beneficiary after establishment of the account (net of any premiums paid to a Medicaid Buy-In program). [§529A(f)]

Any balance that does not go to State would be distributed to the deceased's estate or a designated beneficiary. The amount of investment earnings would be subject to income taxes, but the 10% penalty would not apply.

Section 4 of the Act provides the rules for the partial or full exclusion of such amounts from determinations of eligibility for various programs. The law exempts the first $100,000 in ABLE account balances from counting towards SSI's $2,000 individual resource limit, though account distributions for housing expenses would be treated as income for SSI qualification purposes.

Other ABLE Provisions

The bill also contained a number of other provisions that impact other areas, particularly in its revenue raising sections.

Act Section 105 provides for a modification to the rules for §529 education savings plans, allowing an account contributor or designated benefit to direct investments twice per year. Previously the law had prohibited such direction, but the IRS had indicated that under its regulations to be published eventually a once per year change in investment strategy [Notice 2001-55 and Notice 2009-1] The new law would apply to tax years beginning after December 31, 2014.

Section 206 of the law would also allow Professional Employer Organizations to apply with the IRS to obtain a status of certified PEOs. Such organizations would become solely responsible for their client's payroll taxes, removing the potential liability from the client should the PEO fail to withhold or pay over the taxes. The organization would need to meet certain compliance standards to obtain this status, post a bond with the IRS and submit audited financial statements, as well as paying an annual fee of $1,000.

This program would begin for the first calendar year beginning more than 12 months after the date on enactment.

Section 207 of the Act would exempt from the personal holding income definition dividends from controlled foreign corporation subsidiaries. This rule would be effective for tax years ending on or after the date of enactment.

Section 208 of the Act would subject various penalties that are fixed in dollar amount to an inflation adjustment. Such penalties would include:

- Penalty under §6651 for the failure to file a return or pay a tax;
- Penalty under §6652 to file various information returns, registration statements and other statements;
- Penalty under §6695 on paid preparer obligations;
- Penalty under §6698 for the failure of a partnership to timely file a return;
- Penalty under §6699 for the failure of an S corporation to timely file a return;
- Penalty under §6721(f) to correct information returns; and
- Penalty under §6722(f) for failure to file correct payee statements

The inflation adjustment would take effect for returns required to be filed after December 31, 2014 (which would therefore include 2014 returns).

Section 209 would raise the maximum amount of continuous levy by the IRS against a Medicare provider under §6311(h)(1) to 30% of the payment from the current 15% amount. This change would take effect 180 days after enactment.

Individual Health Care Mandate

Beginning in 2014, most individuals will be required to maintain a minimum level of health insurance coverage or pay a tax for the period in which they do not have the required coverage. [IRC §5000A] Certain individuals will qualify for subsidized rates and/or a credit for the cost of the insurance if they meet certain income requirements and obtain their coverage from a state health care exchange. [IRC §36B]

General Rules

Final regulations (TD 9632, http://www.ofr.gov/OFRUpload/OFRData/2013-21157_PI.pdf) have been issued by the IRS for the individual "shared responsibility" payment under IRC §5000A, first applicable for 2014, that applies when a individual does not maintain minimum essential coverage for any month during the year. Unlike the large employer shared responsibility payment, this payment has not been pushed back to 2015.

The regulations, numbered Reg. §1.5000A-0 through 5, outline the various rules. Reg. §1.5000A-0 gives the table of contents guide to the other regulations. Reg. §1.5000A-1 governs the maintenance of minimum essential coverage and liability for the payment. Reg. §1.5000A-2 explains what is minimum essential coverage, listing types of coverage that will qualify. Reg. §1.5000A-3 outlines the individuals who are exempted from the payments. Reg. §1.5000A-4 outlines the computation of the payment, while Reg. §1.5000A-5 has general rules of administration and procedure.

Liability for payment

The regulations begin at Reg. §1.5000A-1(a) by noting that the penalty applies for each month during a year that a non-exempt individual must maintain minimum essential coverage or pay the shared responsibility payment

An individual who resides outside the United States in a period that would meet either the bona fide residence test or the physical presence test for the foreign earned income exclusion is treated as having minimum essential coverage for each month of such period. Similarly, if the individual is a bona fide resident of a possession of a possession of the United States, he/she is treated as having qualifying coverage for the periods involved. [Reg. §1.5000A-1(c)]

An individual is liable for shared responsibility payments not only for him/herself, but also for any individual whom that person is eligible to claim as a dependent even if the taxpayer does not actually claim the individual as a dependent. [Reg. §1.5000A-1(c)(2)(i)]

Minimum essential coverage

A taxpayer will be treated as having minimum essential coverage for each month in which the individual is enrolled in and entitled to receive benefits in a program described in Reg. §1.5000A-2. [Reg. §1.5000A-1(b)]

Minimum essential coverage includes any of the following coverages [Reg. §1.5000A-2]:

- Government sponsored coverage
    - Medicare

- Medicaid other than
  - Optional coverage of family planning services
  - Optional coverage of tuberculosis related services
  - Coverage of pregnancy related services (however the regulations indicate that guidance will be issued to hold that women covered by this program for a month will not be liable for a shared responsibility payment)
  - Coverage of emergency medical services
- Children's Health Insurance Program (CHIP)
- TRICARE and other programs under chapter 55 of US Code Title 10
- Specific programs under Chapter 17 or 18 of U.S. Code Title 38
  - Medical benefits package for eligible veterans
  - Civilian Health and Medical Program of the Department of Veterans Affairs (CHAMPVA)
  - Comprehensive coverage for certain children of Vietnam Veterans and veterans of service in Korea who are suffering from spina bifida
- Peace Corps plans
- Nonappropriate Fund Health Benefit Program of the Department of Defense

- Employer Sponsored Plans
  - Governmental plans
  - Any plan or coverage offered in the small or large group market within a State
  - A self-insured group health plan offered by the employer to the employee
- Plan in Individual Market (Qualified Health Plans of a State Exchange)

Exempted Individuals

Certain individuals are exempted from the shared responsibility payments. [Reg. §1.5000A-3] Those individuals include:

- Members of recognized religious sects or divisions that have a religious conscious exemption certification
- Individuals who are members of a §501(c)(3) health care sharing ministry (note that it

must have been in existence at all times since December 31, 1999)

- Certain noncitizens
  - Individuals in the country illegally
  - Nonresident aliens
- Incarcerated individuals
- Other Special Exemptions
  - Taxpayers who cannot afford coverage (required annualized contribution is in excess of 8% of household income, with increases following 2014 to the extent premium growth outstrips income growth)
  - Taxpayers with income below the filing threshold (dependents are not tested here—rather the party that could claim them as a dependent must have income below the filing threshold)
  - Members of Indian tribes
  - Taxpayers with short term coverage gaps – an individual not covered for a single continuous period of less than 3 months during the year
  - Taxpayers that have suffered hardships

Shared Responsibility Payment Amount

The shared responsibility payment for a month is 1/12 of the greater of [Reg. §1.5000A-4]

- The flat dollar amount which is the lesser of
  - The applicable dollar amount for each member of the family ($94 for 2014, $325 for 2015, $695 for 2016, indexed for inflation after that). For individuals under 18, the applicable dollar amount is ½ of these amounts
  - 300% of the applicable dollar amount for the year
- A percentage of the taxpayer's household income, set at 1.0% for 2014, 2.0% for 2015 and 2.5% after that

Collecting the Tax

The payment is treated as an excise tax [Reg. §1.5000A-5], not subject to the deficiency procedures. The IRS is not allowed to use certain collection methods to collect this payment, specifically the filing of liens and levies are off limits to the IRS. As well, criminal penalties are waived for failure to comply with the requirement to maintain coverage.

Note that although the IRS is limited in its collection actions, it still has the full right to offset any refund otherwise due the taxpayer against any unpaid portion of the fee. [Reg. §1.5000A-5(b)(3)]

Large Employer Penalty On Health Care Offerings To Full Time Employees (The "Shared Cost" Provision)

On July 2, 2013 the Treasury announced that this provision, originally scheduled to go into effect for tax years beginning after December 31, 2013, would be delayed by one year due to the delay in employer reporting described in the following section. [Article by Mark J. Mazur, Assistant Secretary for Tax Policy, Treasury Notes Blog, July 2, 2013].

On February 10, 2014, additional transition relief was granted as part of the final regulations implemented the shared cost provisions [TD 9655]. This relief delays the applicability of the provision for an additional year for employers with less than 100 employees (that is, those with 50-99 full time employees plus FTEs in 2014 will not be subject to a penalty until 2016) and for large employers subject to the shared responsibility payment in 2015 reduces the percentage from 95% to 70% in 2015 to be deemed to be offering coverage to enough full-time employees to qualify for the §4980H(b) alternative penalty calculation.

As revised, this provision will first be fully effective for tax years beginning after December 31, 2015—that is, 2016 calendar years.

In rough summary, the treatment for 2015 will be

2014 Full time employees plus FTEs	Affordable Care Act Treatment for 2015
>25 (in 2015)	May qualify for Small Employer Credit [IRC §45R] if: • Obtain coverage from SHOP Exchange to all employees • Meet average wage test
25-49	Not eligible for credit and not subject to shared cost provisions
50-99	One year waiver from applicability of shared cost provisions
100+	If fail to offer minimum essential coverage to 70% of full-time employees, subject to monthly §4980H(a) penalty of $(\text{Full time employees-80}) \times \frac{\$2{,}000}{12}$ If any employee qualifies for and receives assistance
	If offer minimum essential coverage to 70% of all full-time employees but coverage is either unaffordable or fails to provide minimum value, subject to monthly §4980H(b) penalty of $\text{Assisted Employees} \times \frac{\$3{,}000}{12}$ or, if less, the §4980H(a) penalty.

For 2016 and later years the rules will be:

Prior Year Full time employees plus FTEs	Post 2015 Affordable Care Act Treatment
>25 (in current year)	May qualify for Small Employer Credit [IRC §45R] if: • Obtain coverage from SHOP Exchange to all employees • Meet average wage test • Not more than one year past first year was an eligible small employer and offered SHOP exchange coverage
25-49	Not eligible for credit and not subject to shared cost provisions
50+	If fail to offer minimum essential coverage to 95% of full-time employees, subject to monthly §4980H(a) penalty of $$(\text{Full time employees-30}) \times \frac{\$2{,}000}{12}$$ If any employee qualifies for and receives assistance
	If offer minimum essential coverage to 95% of all full-time employees but coverage is either unaffordable or fails to provide minimum value, subject to monthly §4980H(b) penalty of $$\text{Assisted Employees} \times \frac{\$3{,}000}{12}$$ or, if less, the §4980H(a) penalty.

Provision Basics

Large employers that failed to offer full-time employees the option to enroll in a plan offering "minimum essential coverage" who have employees making use of premium tax credit or cost-sharing reduction could be subject to a payment based on all full time employees.

As well, employers who do offer a qualifying plan but have one or more employees who are allowed a premium tax credit or cost-sharing reduction may also face a requirement to make a payment for those employees who are eligible for assistance--thus subjecting the employer to a fee for "excess" cost sharing for the plan imposed on the employee. [IRC §4980H]. The payment required is the "applicable payment amount" times the number of employees for which a payment is required for a month [§§4980H(a) and (b)].

Large Employer Defined

Not all employers are subject to the "pay or play" provisions of IRC §4980H. Only "large" employers, as defined by this section, are subject to the tax.

Regulation §54.4980H-2 provides for determination of which employers are to be considered "applicable large employers" for purposes of this provision.

Generally the employer will compute a total of full time employees plus full-time equivalents for each month of the prior year. Then the employer will compute an average based on the twelve months.

The monthly computation of this number (described in more details in the following subsections) is summarized below:

Full Time Employees – Employees who averaged more than 30 hours/week during the month ______________

Full Time Equivalents

Total month hours for all employees other than those determined to be full time employees above, limited to 120 hours for any single employee ______________

Divide total hours by 120 ______________

Total Monthly Full-Time Plus FTE ______________

Basic Provisions

A "large employer" is defined as one that employed, on average, more than 50 employees on business days during the previous calendar year [§4980H(c)(2)(A)]. However a special rule applies to exempt employers that are driven over the 50 employee limit by seasonal employees--if the employer's workforce exceeds 50 employees for less than 120 days during the calendar year and the employees in excess of 50 employed during those days were seasonal workers, the employer is not treated as a large employer [§4980(c)(2)(B)].

Employers treated as related under §§414(b), (c), (m) or (o) will be treated as one employer for purposes of computing the number of employees [§4980H(c)(2)(C)(i)]. Predecessor employers will be treated as the employer for the purposes of these tests [§4980H(c)(2)(C)(iii)].

If an employer was not in existence in the prior year, the determination will be made based on the number of employees that it is "reasonably expected" the employer will employ on business days in the current year [§4980H(c)(2)(C)(ii)]. Solely for purposes of determining if an employer is a large employer, hours of service for employees who are not full time employees will be aggregated for the month. Those total hours will be divided by 120, and the resulting number of full-time equivalents will be added to the actual full time employees [§4980H(c)(2)(E)].

Applying the "Previous Year" Test for Inclusion

The regulations provide first for a set of calculations an employer will use to determine if the employer has gone over the 50 employee limit for the prior year. An employer that does not meet the 50 employee test for the prior year is not subject to the tax in the current year.

For most employers this calculation won't be an issue, because they are either clearly well above this limit or clearly well below it. Joe's Hardware that issued 5 W-2s last year is clearly not covered by this rule, while Microsoft will clearly find far more than 50 employees when running this calculation.

However for the unlucky employer sitting right at this cut-off point, simply making the determination of whether or not the employer is "in" or "out" will be a relatively messy undertaking, made more so since a large portion of employers facing this problem will not have large accounting and human resource staffs to devote to handling this matter.

To compute the number of employees, the employer must determine, on a monthly basis, the total of its full time employees <u>plus</u> full time equivalents (FTEs) for the month. An average of the 12 months is computed, rounded down to a whole number (thus an average of 49.9 would be rounded to 49, not 50). If the average is 50 or more, the employer will be an "applicable large employer" covered by this rule for the following year. [Reg. §54.4980H-2(b)(1)]

Note that a "full time equivalent" calculation, while used to determine whether an employer comes under the "pay or play" rule, does not impact how many employees would be subject to the actual pay or play penalty each month.

If an employer is not in existence on any day during the preceding year, it will be treated as an "applicable large employer" if it is both:

- Reasonably expected that the employer will employ an average of at least 50 full-time employees plus FTEs on business days during the year and

- The employer actually does employ that number during the year [Reg. §54.4980H-2(b)(3)]

Clearly new employers who take the position they did not expect to employ sufficient employees but find that, in reality, they did go over the 50 employee limit will need to be ready to show the "reasonableness" of their original projection.

The IRS gives this example of applying the new employer rule at Reg. §54.4980H-2(d), Example 5:

> Example 5. New employer. (i) Facts. Corporation A is incorporated on January 1, 2015. On January 1, 2015, Corporation A has three employees. However, prior to incorporation, Corporation A's owners purchased a factory intended to open within two months of incorporation and to employ approximately 100 employees. By March 15, 2015, Corporation A has more than 75 full-time employees.
>
> (ii) Conclusion. Because Corporation A can reasonably be expected to employ on average at least 50 full-time employees on business days during 2015, and actually employs an average of at least 50 full-time employees on business days during 2015, Corporation A is an applicable large employer (and an applicable large employer member).

<u>Shorter Period for Determining Applicable Large Employer Status for 2015</u>

An elective one time only special rule applies to the determination of applicable large employer status for 2015. The employer may determine the number of full-time employees plus FTEs by using any consecutive six-month period during 2014 rather than using the entire calendar year.

The IRS notes that this will employers to either choose an early period (to have time to make any changes to their plan or establish a plan) or a later period (to have time to establish information gathering procedures to provide the necessary information).

Even if the six month period is used, the seasonal worker rule (described below) must be applied for the entire year.

The IRS noted that some comments received on the similar rule in the proposed regulations complained that schools, by electing to include summer months when no in-school service is required, could end up with artificially low counts that would be significantly different than the whole year count. While the IRS agreed this is possible, the IRS decided against providing for a special rule to address this issue since this six-month rule will only be applicable for one year.

Seasonal Worker Rule

A special rule applies to exempt employers pushed over the limit by "seasonal workers" which is found at Reg. §54.4980H-2(b)(2).

If the employer has in excess of 50 full-time employees plus FTEs for 120 days or less in the year, and the employees in excess of 50 employees during that period consist of seasonal employees, then the employer will not be considered an "applicable large employer" for the following year. An employer is allowed to treat 4 calendar months as being equivalent to 120 days for this purpose.

Reg. §54.4980H-1(a)(39) defines a seasonal worker as a "worker who performs labor or services on a seasonal basis as defined by the Secretary of Labor, including (but not limited to) workers covered by 29 CFR 500.20(s)(1), and retail workers employed exclusively during holiday seasons." Employers are allowed to use a reasonable, good faith interpretation of the term "season worker" for workers not covered by 29 CFR 500.20(s)(1).

The IRS provides the following pair of seasonal employee examples at Reg. §54.4980H-2(d):

<u>Example 3. Seasonal worker exception</u>. (i) Facts. During 2015, Employer V has 40 full-time employees for the entire calendar year, none of whom are seasonal workers. In addition, Employer V also has 80 seasonal workers who are full-time employees and who work for Employer V from September through December 2015. Employer V has no FTEs during 2015.

(ii) Conclusion.Before applying the seasonal worker exception, Employer V has 40 full-time employees during each of eight calendar months of 2015, and 120 full-time employees during each of four calendar months of 2015, resulting in an average of 66.67 full-time employees for the year. However, Employer V's workforce exceeded 50 full-time employees (counting seasonal workers) for no more than four calendar months (treated as the equivalent of 120 days) in calendar year 2015, and the number of fulltime employees would be less than 50 during those months if seasonal workers were disregarded. Accordingly, because after application of the seasonal worker exception described in paragraph (b)(2) of this section Employer V is not considered to employ more than 50 full-time employees, Employer V is not an applicable large employer for 2016.

<u>Example 4 (Seasonal workers and other FTEs).</u> (i) Facts. Same facts as Example 3, except that Employer V has 20 FTEs in August, some of whom are seasonal workers.

(ii) Conclusion. The seasonal worker exception described in paragraph (b)(2) of this section does not apply if the number of an employer's full-time employees (including seasonal workers) and FTEs exceeds 50 for more than 120 days during the calendar year. Because Employer V has at least 50 full-time employees for a period greater than four calendar months (treated as the equivalent of 120 days) during 2015, the exception described in paragraph (b)(2) of this section does not apply. Employer V averaged 68 full-time employees in 2015: [(40 x 7) + (60 x 1) + (120 x 4)] ÷ 12 = 68.33, and accordingly, Employer V is an applicable large employer for calendar year 2016.

Calculating FTEs for Purposes of Determining "Applicable Large Employer" Status

To apply the "50 employee" test, an employer must first classify all employees during the month into two categories

- Full-time employees – these are employees who averaged working more than 30 hours a week during the month. As was noted above, each of these employees will count as "1" in the calculation

- All other employees – all employees who did not meet the 30 hour average during the month.

For each employee in the "all other employees" class, the employer determines the lesser of the total hours the employee worked during the month or 120 hours (that is, no employee can add more than 120 hours to this calculation). After determining the number for each of the "other employees" the hours are totaled and divided by 120. [Reg. §54.4980H-2(c)(2)]

Hours of service are determined under the same provisions as are found at Reg.§54.4980-H3(b) for determining hours of service when determining if the employee of an applicable large employer is a full-time employee

The regulations provide that fractions must be considers in computing FTEs for each month, and that an employer may round the monthly FTE calculated amount to the nearest $1/100^{th}$.

The IRS gives this example of the calculation at Reg. §54.4980H-2(d), Example 2:

Example 2 (Applicable large employer with FTEs). (i) Facts. During each calendar month of 2015, Employer W has 20 full-time employees each of whom averages 35 hours of service per week, 40 employees each of whom averages 90 hours of service per calendar month, and no seasonal workers.

(ii) Conclusion. Each of the 20 employees who average 35 hours of service per week count as one full-time employee for each calendar month. To determine the number of FTEs for each calendar month, the total hours of service of the employees who are not full-time employees (but not more than 120 hours of service per employee) are aggregated and divided by 120.

The result is that the employer has 30 FTEs for each calendar month (40 x 90 = 3,600, and 3,600 ÷ 120 = 30). Because Employer W has 50 full-time employees (the sum of 20 full-time employees and 30 FTEs) during each calendar month in 2015, and because the seasonal worker exception is not applicable, Employer W is an applicable large employer for 2016.

First Year as an Applicable Large Employer

Under Reg. §54.4980H-2(b)(5) relief is granted to certain employers that were not previously an applicable large employer. If an employee was not offered coverage by the employer at any point in the prior taxable year, so long as an offer of coverage is made on or before April 1 of the first calendar year of being an applicable large employer, no penalty under either §4980H(a) will be due with regard to that employee.

Relief from the §4980H(b) penalty will be available only if the coverage offered provides minimum value.

In either case if the employer fails to offer qualifying coverage by April 1 the penalty may apply retroactively for the first three months assuming the employee qualifies for assistance with his/her premiums for an exchange policy. Again, only an offer of minimum essential coverage is needed for §4980H(a) relief, but the policy must also provide minimum value to meet §4980H(b).

This rule is a one-time relief rule. If an employer is an applicable large employer for Year 1 but has a reduction in employees in Year 1 that causes the employer to not be an applicable large employer in Year 2, and the employer is again an applicable large employer in Year 3 (due to a return to its prior employment levels in Year 2), the employer will not have until April 1 of Year 3 to offer coverage to those not offered in Year 2.

2015 Transitional Relief

Special rules are provided in the preamble to the final regulations found in TD 9655 [Explanation and Summary of Comments, Section XV.D.6.a] for tax year 2015. To be eligible for an exclusion from the shared cost provisions for 2015 an employer must meet each of the following conditions.

Limited Workforce Size

The most well publicized, but not the only, criteria to meet relief is the workforce size requirement. To be eligible for relief, the employer must employ, on average, less than 100 full time employees plus FTEs during 2014. The computation is made using the provisions described above for testing whether an employer is an applicable large employer. [Explanation and Summary of Comments, Section XV.D.6.a.1]

But, as noted, merely having between 50 and 99 as the employer average full-time employees plus FTEs in 2014 is not enough to obtain relief. The other criteria noted below must be met.

What if the employer wasn't in existence during 2014? The transition rule provides special rules for such employers. Generally the same "reasonable expectation" of having fewer than 100 full time employees during 2015 will be applied as will apply for new employers under the general applicable large employer provisions.

If the employer meets this requirement, then it must meet the remaining standards described below, measured from the date the employer is first in existence and give the same required certification. [Explanation and Summary of Comments, Section XV.D.6.c]

Maintenance of Workforce Size

To prevent employers from terminating employees or reducing the hours employees work to meet the limited workforce size requirements, the transition rule imposes rules to require the maintenance of workforce size and hours during the remainder of 2015, specifically the period from February 9, 2014 through December 31, 2014.

This is an anti-abuse rule, since it is limited to reductions that are undertaken to reduce the numbers below the 100 trigger. The preamble notes that reductions in workforce for bona fide business reasons will not be counted for this purpose. Of course, the burden will be on the employer to show the bona fide reason. [Explanation and Summary of Comments, Section XV.D.6.a.2]

The preamble does provides the following explanation of bona fide reasons:

For example, reductions of workforce size or overall hours of service because of business activity such as the sale of a division, changes in the economic marketplace in which the employer operates, terminations of employment for poor performance, or other similar changes unrelated to eligibility for the transition relief provided in this section XV.D.6 are for bona fide business reasons and will not affect eligibility for that transition relief.

Maintenance of Health Coverage

The 2015 transition rule also requires the employer to maintain a "comparable" level of health care coverage for employees as existed on February 9, 2014 to obtain relief. The rule states that the employer may not eliminate for materially reduce the health coverage, if any, offered on February 9, 2014 during the coverage maintenance period [Explanation and Summary of Comments, Section XV.D.6.a.3]

Note that if the employer offered no coverage on February 9, 2014 this test will automatically be met.

The coverage maintenance period for an employer with a calendar year plan will run from February 4, 2014 through December 31, 2015. If the employer maintains a plan on a non-calendar year, the coverage maintenance period will run from February 4, 2014 through the end of the plan year that begins in 2015.

While the coverage maintenance period is extended past the end of 2015 for non-calendar year plans, the good news is that the relief is also extended during that period. As well, such an employer will still qualify for relief in calendar year 2015 even if it eventually fails to maintain coverage where the failure takes place in 2016. [Explanation and Summary of Comments, Section XV.D.6.b]

For employers that offered coverage on that date, the relief provision provides a safe harbor test to show that no material reduction has taken place. Under the safe harbor, a taxpayer will not be treated as eliminating or materially reducing coverage if:

- The employer continues to offer each employee who is eligible for coverage during the coverage maintenance period an employer contribution toward the cost of employee-only coverage that either
    - Is at least 95 percent of the dollar amount of the contribution toward such coverage that the employer was offering on February 9, 2014, or
    - Is the same (or a higher) percentage of the cost of coverage that the employer was offering to contribute toward coverage on February 9, 2014;
- In the event there is a change in benefits under the employee-only coverage offered, that coverage provides minimum value after the change; and
- The employer does not alter the terms of its group health plans to narrow or reduce the class or classes of employees (or the employees' dependents) to whom coverage under those plans was offered on February 9, 2014.

Note the key issue above will involve any change in benefits. If an employer does not maintain the same benefits as it did previously, the new plan is going to need to be tested under the minimum value rules.

Certification of Eligibility

Finally, an employer availing itself of this relief will need to provide a certification on a form, yet to be announced, that it meets the criteria outlined above. [Explanation and Summary of Comments, Section XV.D.6.a.4] The certification will be part of the "large employer" report to be required for 2015 under the reporting rules of IRC §6056 where employers give details about coverage provided and its employees.

IRS Example

The IRS provides the following example of the applicability of the relief provision:

> **Facts.** As of February 9, 2014, Employer A sponsors a group health plan with a calendar year plan year under which 40 of its full-time employees are offered coverage with an employer contribution of $300 per month for employee-only coverage. The offer of coverage is affordable with respect to some, but not all, of Employer A's full-time employees.
>
> During the period from February 9, 2014, through December 31, 2014, two of Employer A's employees voluntarily terminate employment and Employer A terminates three employees because of the non-renewal of a customer contract but does not otherwise reduce the size of its workforce or reduce any employee's hours of service.
>
> Had those five employees continued in employment throughout 2014, the employer would have had an average of 100 full-time employees (including FTEs) on business days in 2014. However, as a result of the terminations, it had an average of only 97 full-time employees (including FTEs) for business days in 2014.
>
> During the coverage maintenance period, Employer A does not change the eligibility requirements for the group health plan (including not amending it to eliminate its existing health coverage for dependents) and continues to make an employer contribution of $300 per month toward the cost of employee-only coverage that provides minimum valve. Employer A certifies in a timely manner as to its eligibility for the transition relief.
>
> **Conclusion.** Employer A will not be subject to an assessable payment under section 4980H(a) or (b) for 2015.

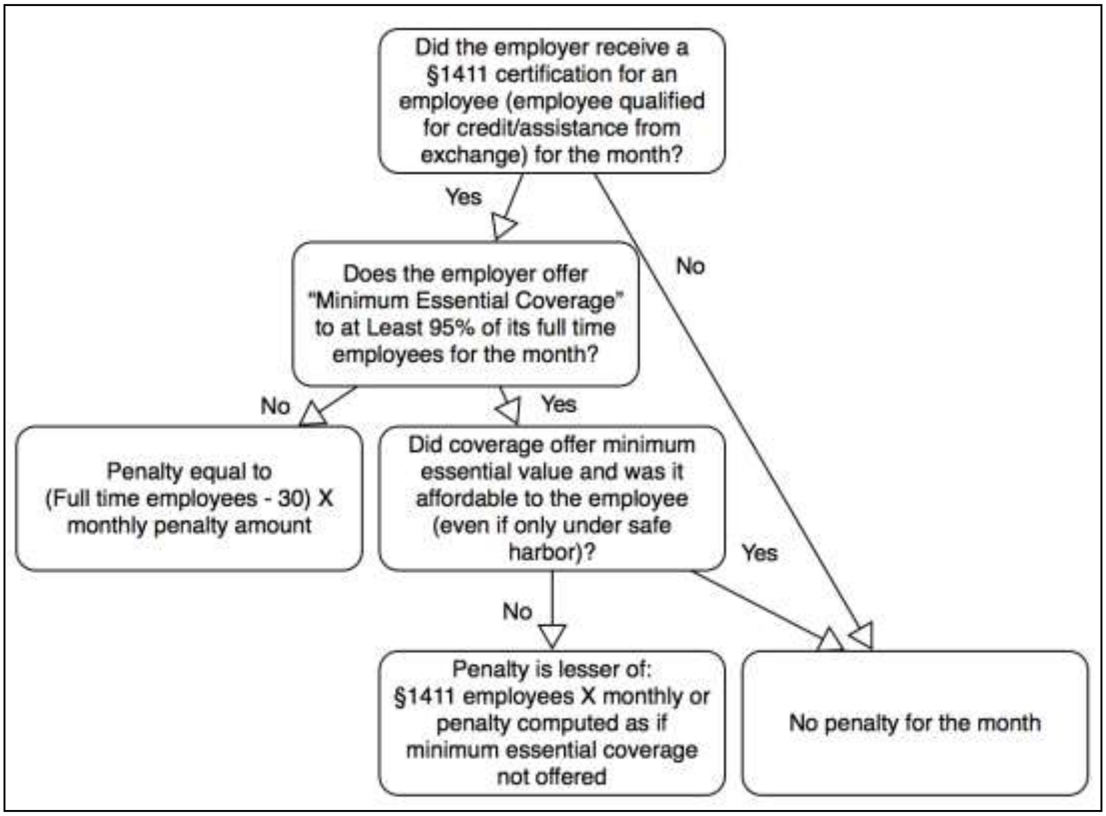
Applicable Payment Amount

The applicable payment amount for the §4980H(a) penalty is set by statute to being at 1/12 of $2,000 (or $166.67) [§4980H(c)(1)]. For the alternative penalty under §4980H(b), the applicable amount is set at $3,000 (or $250). [IRC §4980H(b)(1)]. In both cases the amounts indexed for inflation after 2014 [§4980H(c)(5)].

Key Coverage Definitions

Two key definitions are crucial to understanding the rules applicable to "large" employers subject to the shared responsibility payment under IRC §4980H.

The issue is key because it determines how a “pay or play” penalty, if it applies, will be computed. Roughly summarized, the penalty rules work as shown below:



The first concept is whether a program offers “minimum essential coverage” while the second concept looks at whether the program offers “minimum value” in its coverage. Employers need to understand whether their plan offers one or both of these.

<u>Minimum Essential Coverage</u>

One of the definitions that impacts this area is that of “minimum essential coverage” since the provision of that to employees, even if not meeting the minimum value rules or being “unaffordable,” will nevertheless allow the employer to qualify for a lower shared responsibility payment based solely on employees who actually receive assistance.

Minimum essential coverage offered by an employer includes coverage offered by an employer offered in small or large group market of the state (within the meaning found in 42 USC §300gg-91(b)), any governmental plan (within the meaning of 42 USC §300gg-91(d)(8)), and any grandfathered plan. [IRC §5000A(f)(2), Proposed Regulation §1.5000A-2(c)]

Minimum Value

A second consideration is whether an employer's plan offers minimum value. For these purposes, the term "minimum value" has the same meaning as it does under IRC §36B (the individual refundable credit for health care coverage). [Reg. §54-4980H-1T(a)(24)]

An employer plan is deemed to offer "minimum value" if its total share of allowed costs of benefits provided to an employee is at least an "MV Percentage" of 60%. [Reg. §1.36B-6(a)]

The MV percentage is an actuarial computation consisting of the plan's anticipated spending under an essential health plan (EHB) benchmark over the total such allowed charges for the standard population under such EHB. [Reg. §1.36B-6(c)(1)]

Contributions to an HSA by an employer are considered as part of the anticipated employer spending in this calculation. [Reg. §1.36B-6(c)(3)] Amounts made available under health reimbursement arrangements integrated with the employer sponsored plan are taken into account if the amounts may only be used to reduce cost-sharing for covered expenses. [Reg. §1.36B-6(c)(4)] In both cases, the adjustment is based on expected spending for health costs in the benefit year. [Reg. §1.36B-6(c)(5)]

The regulations offer the following four options for employer to determine if a plan offers minimum value:

- Use of the "MV Calculator" provided by the Department of Health and Human Services (with permitted adjustments based on actuarial calculations for benefits outside the parameters of the MV calculator)

- Using a published safe harbor established by the Department of Health and Human Services and the IRS

- Actuarial calculations, determined in accordance with Reg. §1.36B-6(f), if the plan has "nonstandard features" that are not compatible with the MV Calculator that may materially affect the MV percentage or

- For small group plans, conformity with the requirements for a "metal" level of coverage (bronze, silver, gold or platinum).

Employer Not Offering "Minimum Essential Coverage"-§4980H(a) Penalty

If an employer does not offer its employees the opportunity to enroll in a plan offering minimum essential coverage (MEC), the monthly payment amount is the total number of full time employees, reduced by 30 [§4980H(c)(2)(D)(i)(I)], times the applicable payment [§4980H(a)]. In this case even employees for whom no credit or cost sharing was involved will be included in the calculation of the required payment, and is triggered if a single employee enrolls in a plan and qualifies for a credit or cost-sharing.

Triggering the Penalty

The penalty is triggered if the large employer receives even a single "Section 1411 Certification" with regard to one of its employees. The "Section 1411" referred to is not the IRC §1411, but rather a provision administered by the Department of Health and Human Services. Essentially it is given to an employee that qualifies for assistance or a credit for coverage obtained from the applicable exchange.

The penalty under §4980H(a) applies if the employer has failed to offer minimal essential coverage to at least 95% of its full-time employees. [Reg. §54.4980H-4(a)] However see the transition rules for special provisions applicable to 2015.

Offer of Minimum Essential Coverage to Full-Time Employees

An employer is treated as offering minimum essential coverage to all full-time employees and their dependents (and thus exempt from the §4980H(a) penalty for each month it meets the 95% threshold) if it offers full-time employees, at least once during the plan year, the effective opportunity to enroll in (or decline enrollment in) coverage for themselves and their dependents. [Reg. §54.4980H-4(b)]

An "effective opportunity" is judged based on the overall facts and circumstances of the opportunity. Specifically the regulation notes that the following factors are part of that consideration:

- Adequacy of the notice of availability of coverage
- Period of time during the offer may be accepted and
- Any other conditions imposed on the offer [Reg. §54.4980H-4(a)]

Coverage must be offered for each day of the calendar month generally in order for the employer to be treated as offering coverage to that employee. However, the employer is not required to offer coverage for the remainder of the month so long as the employee would have been offered coverage for the entire month had he/she remained employed. [Reg. §54.4980H-4(c)]

An employer must offer both an option to accept or decline coverage generally. However, if the program offers minimum value and the cost to the employee for the month does not exceed 9.5% of 1/12 of the federal poverty line for a single individual for the calendar year, an employer will not be required to offer an option to decline coverage. Thus, for example, if the employer pays the entire cost of coverage the employer does not need to offer an employee the option of declining coverage. But an employer cannot require the employee to acquire coverage that doesn't offer minimum value or is "unaffordable" since, as the preamble to the final regulations notes, such an employee may be eligible for the premium tax credit. [Reg. §54.4980H-5(b)(1)]

The employer can, however, require that an employee must affirmatively "opt-out" of coverage for the following year if the employee enrolled in the prior year.

Note that merely because this offer removes the employer from §4980H(a) penalty exposure, the employer may still be exposed to a penalty (though presumably lesser) under §4980H(b).

Allocation of the 30 Employee Reduction to Members of Group

If an applicable large employer is a member of group treated as a single employer, the member is allocated to the member by using the following formula:

$$30 \times \frac{\text{Full time employees of member}}{\text{Full time employees of group}}$$

If the member's allocable portion of the 30 is less than 1, it will be rounded up to one. The regulations specifically recognize that application of this rounding rule will cause the total reduction for the group to be greater than 30. [Reg. §54.4980H-4(e)]

The IRS provides the following example of applying the allocation and rounding rules:

> Example. (i) Facts. Applicable large employer member Z and applicable large employer member Y are the two members of an applicable large employer. Applicable large employer member Z employs 40 full-time employees in each calendar month of 2017. Applicable large employer member Y employs 35 full-time employees in each calendar month of 2017.
>
> Assume that for 2017, the applicable payment amount for a calendar month is $2,000 divided by 12. Applicable large employer member Z does not sponsor an eligible employer-sponsored plan for any calendar month of 2017, and receives a Section 1411 Certification for 2017 with respect to at least one of its full-time employees. Applicable large employer member Y sponsors an eligible employer-sponsored plan under which all of its full-time employees are eligible for minimum essential coverage.
>
> (ii) Conclusion. Pursuant to section 4980H(a) and this section, applicable large employer member Z is subject to an assessable payment under section 4980H(a) for 2017 of $48,000, which is equal to 24 x $2,000 (40 full-time employees reduced by 16 (its allocable share of the 30-employee offset ((40/75) x 30 = 16)) and then multiplied by $2,000). Applicable large employer member Y is not subject to an assessable payment under section 4980H(a) for 2017.

2015 Transitional Rules

The final regulations for the shared cost provisions contained in TD 9655 provided for various types of transition relief on the §4980H(a) penalty.

Offer of Coverage to 70% (Rather Than 95%)

Generally to be exempt from the §4980H(a) penalty (but not necessarily the §4980H(b) penalty), an applicable large employer must offer the opportunity to enroll in coverage to at least 95% of its full time employees and their dependents, tested on a monthly basis. Under a special rule in the final regulations if the employer fails to offer to no more than 5 full-time employees the employer will be treated as meeting the 95% test even if the 5 employees amount to more than 95% of the employer's full-time employees.

In 2015 an employer will not subject to the penalty under §4980H(a) for any month in which the employer makes the offer of coverage to at least 70% of its full-time employees. The preamble makes clear that such an employer will still be potentially liable for the alternative penalty under §4980H(b). [Explanation and Summary of Comments, Section XV.D.7a]

Dependent Coverage

The 95% (or for transition purposes 70%) offer requires offering coverage to dependents. The preamble to the final regulations offer a transition period to enable plans that did not previously make an offer of dependent coverage to do so.

The proposed regulations had provided relief for plans that took steps during a plan year beginning in 2014 to provide dependent coverage. Those plans would not be subject to a penalty for that plan year solely on account of a failure to offer dependent coverage during that year. The final regulations extend this relief to cover plan years beginning in 2015. [Explanation and Summary of Comments, Section XV.D.5]

There are limits to this relief. It will not apply if an employer had offered dependent coverage in the plan year beginning in 2013 or 2014—so an employer who dropped dependent coverage will not escape the penalty. If the employer offered coverage to some, but not all, dependents, the relief only applies to those dependents who were not offered coverage in the 2013 or 2014 plan years.

80 Employee Monthly Reduction

Under the standard calculation of a penalty under §4980H(a), the penalty for an employer who does not offer minimum essential coverage to a sufficient number of employees during the month is potentially subject to a penalty computed on a per full-time employee basis after reducing the number of full-time employees by 30. If the employer is a member of a group of employers that are combined for purposes of these rules, the 30 employee exclusion is allocated among the members of the group.

The preamble to final regulations, the 30 is temporary boosted to 80 for any applicable large employer with more than 100 full-time employees plus FTEs on average in 2014. This same boost to 80 will be used in computing the cap on any penalty applicable under the alternative calculation under §4980H(b) for 2015 and any calendar months in 2016 that fall within the employer's 2015 plan year. [Explanation and Summary of Comments, Section XV.D.7b]

In a footnote to the preamble, the IRS explains that 80 was used to maintain the same 20 employee difference between the threshold level (100 under the transition rules) and the exclusion that exists under the Code.

One item to note is that this rule does require the employer meet the "more than 100" test. If an employer with more than 50 full time employees plus FTEs in 2014 fails to qualify for the numeric transitional exclusion (for instance due to eliminating a previously existing health benefit) it would appear that employer would be stuck with the lower 30 subtraction level, even though a larger employer that took the same action would be able to make use of the higher 80 subtraction number in 2015.

January of 2015 Offer of Coverage

Only for the month of January 2015, an employer will be treated as offering coverage as of the first day of the month for an employee if the offer is made as of the first day of the first pay period beginning in January 2015. [Explanation and Summary of Comments, Section XV.D.4]

Note that this rule will not apply for any other month. Thus in order to be deemed to have offered coverage as of the first day of February 2015, an employer who only offers coverage on the first day of a pay period will need to make any required new offer as of the last pay period beginning in January 2015.

Employer Offering "Unaffordable" Minimum Essential Coverage-§4980H(b)

If the employer offers minimum essential coverage, but has at least one employee who qualifies for the tax credit or cost-sharing, the payment will be the number of assisted employees times a higher applicable payment amount (1/12 of $3,000 for 2015) due to the plan being unaffordable or failing to offer minimum value [§4980H(b)].

In this case a maximum penalty cap is computed using the 30 employee exclusion and lower applicable payment amount mentioned above--the total required payment will be no more than the number of full-time employees reduced by 30 times the lower applicable payment amount [§4980H(c)(2)(D)(i)(II)], thus insuring an employer offering coverage can be no worse off than one who offers no coverage.

Triggering the Penalty

As with the §4980H(a) penalty, this penalty is not triggered unless the employee receives a Section 1411 Certification with regard to any employee. Even if that certification is received, the penalty will still not apply to that employee in the following conditions:

- New full-time employees in the first three months of employment
- New variable or seasonal employees in the initial measurement period and associated administrative period (described below)
- The employee was offered the opportunity to enroll in minimum essential coverage that
  - Satisfied the minimum value rules and
  - Met one or more of the affordability safe harbors [Reg. §54.4980H-5(a)]

Offer of Coverage

The same rules apply for offer of coverage under the §4980H(b) penalty as are described above for the §4980H(a) penalty. [Reg. §54.4980H-5(b)]

Members of Group

If an individual was employed by more than one member of the large employer group, the penalty is allocated among the group in accordance with the number of hours of service the employee had with each member during the month. [Reg. §54.4980H-5(d)]

Affordability

There is both a general rule and a number of safe harbors that apply to affordability. Generally an employer will not be able to determine if the general rule affordability provisions will apply to an employee, so the regulations provide for safe harbors an employer may elect to use to insure any required payments will be deemed affordable.

General Rule

Affordability of an employer plan is determined generally under the rules applicable for purposes of premium tax credit or cost reduction provided by IRC §36B. Per §36B(c)(2)(C)(i) such coverage is not affordable if the employee's contribution exceeds 9.5% of the employee's household income for the year, after certain adjustments.

Household income is the adjusted gross income of all members of the family (including the employee's spouse and dependents), increased by the following items:

- Amounts excluded from income under §911 (foreign earned income exclusion)
- Tax exempt income received or accrued during a year
- Social security benefits not otherwise included in the taxpayer's income

Safe Harbors

Safe harbors are included in the regulations to enable an employer to design a plan that will assure the contribution will be treated as "affordable" for purposes of the §4980H(b) penalty even if the employee nevertheless qualifies for and receives assistance under §36B.

To make use of the safe harbor the employer must offer a policy that both meets the minimum essential coverage (MEC) provisions and the minimum value rules. [Reg. §54.4980H-5(e)(1)] While offering a program that provides MEC allows the employer to escape the §4980H(a) penalty (full-time employees minus 30 times applicable payment for each month), that is not sufficient to escape the §4980H(b) penalty if the plan doesn't meet the minimum value provisions.

The safe harbor chosen does not have to be applied to all employees. Rather an employer may apply a safe harbor only to a reasonable category of employees. The IRS indicates reasonable categories include the following:

- Specified job categories
- Hourly vs. salaried employees (or other similar "nature of compensation" situations)
- Geographic locations

However, an enumerated list of employees will not be a reasonable category for these purposes. [Reg. §54.4980H-5(e)(2)(i)]

Summary of Safe Harbor Options – Required Employee Contributions Must Always Be Less than 9.5% of:
➢ **W-2 Wages** ➢ **Employee's Rate of Pay** ➢ **Federal Poverty Rate for a Single Individual**

The rules provide for three safe harbors. First is the W-2 safe harbor. An employee will be deemed to have been offered affordable coverage if offered MEC that provides minimum value and the employee's contribution for the lowest cost self-only coverage is not more than 9.5% of:

- For employees offered coverage for the entire year, the amount of the employee's W-2 wages reported on that year's W-2

- For employees offered coverage for only a portion of the year, the wages number is calculated by multiplying the total year W-2 wages by the ratio of the number of full months coverage was offered divided by the total number of months the individual was employed. [Reg. §54.4980H-5(e)(2)(ii)]

The IRS rejected a comment in the final regulations that an employer should be required to add back reductions in salary due to items like §125 or §401(k) plan elections. The IRS points out in the preamble that an employee's household income for the credit is not increased by such items, so it is not appropriate to require the employer to add back these items.

The second option is the rate of pay safe harbor. Under this rule a plan offering MEC with minimum value will be considered affordable if the employee's contribution for the lowest cost self-only coverage is not more than 9.5%:

- For hourly employees, the employee's hourly rate of pay times 130 as of the first day of the coverage period (normally the plan year)

- For salaried employees, the monthly salary is used as the factor. An employer may use any reasonable and consistent method to convert a salary expressed in a "per pay period" amount to a monthly amount. [Reg. §54.4980H-5(e)(2)(iii)]

The preamble to the final regulations makes clear that the IRS looks at this as providing a method to design a benefit program to offer automatically affordable coverage by knowing the affordable amount for an employee at the beginning of the plan year.

If an employee's hourly rate of pay is reduced during the year, the safe harbor is applied separately to each month, using the lower of the beginning of plan year rate of pay or the lowest rate of pay of the employee for the month times 130. However, if a salaried employee's pay is reduced, including due to a reduction of hours, the safe harbor may not be used. [Reg. §54.4980H-5(e)(2)(iii)]

Note that the above tests are not impacted by factors such as unpaid leave taken by the employee—thus this method may result in a higher safe harbor than the W-2 method in many cases.

The final safe harbor is the federal poverty line safe harbor. Under this provision, the program is affordable so long as the contribution required of an employee is no more than 9.5% of a monthly amount determined as the federal poverty line for a single individual for the calendar year divided by 12. [Reg. §54.4980H-5(e)(2)(iv)]

The IRS has provided the following examples to apply the safe harbors:

> Example 1 (Form W-2 wages safe harbor). (i) Facts. Employee A is employed by Employer Z consistently from January 1, 2015, through December 31, 2015. In addition, Employer Z offers Employee A and his dependents minimum essential coverage during that period that provides minimum value. The employee contribution for self-only coverage is $100 per calendar month, or $1,200 for the calendar year. For 2015, Employee A's Form W-2 wages with respect to employment with Employer Z are $24,000.
>
> (ii) Conclusion. Because the employee contribution for 2015 is less than 9.5 percent of Employee A's Form W-2 wages for 2015, the coverage offered is treated as affordable with respect to Employee A for 2015 ($1,200 is 5 percent of $24,000).
>
> Example 2 (Form W-2 wages safe harbor). (i) Facts. Employee B is employed by Employer Y from January 1, 2015, through September 30, 2015. In addition, Employer Y offers Employee B and his dependents minimum essential coverage during that period that provides minimum value. The employee contribution for self-only coverage is $100 per calendar month, or $900 for Employee B's period of employment.
>
> For 2015, Employee B's Form W-2 wages with respect to employment with Employer Y are $18,000. For purposes of applying the affordability safe harbor, the Form W-2 wages are multiplied by 9/9 (9 calendar months of coverage offered over 9 months of employment during the calendar year) or 1. Accordingly, affordability is determined by comparing the adjusted Form W-2 wages ($18,000) to the employee contribution for the period for which coverage was offered ($900).
>
> (ii) Conclusion. Because the employee contribution for 2015 is less than 9.5 percent of Employee B's adjusted Form W-2 wages for 2015, the coverage offered is treated as affordable with respect to Employee B for 2015 ($900 is 5 percent of $18,000).
>
> Example 3 (Form W-2 wages safe harbor). (i) Facts. Employee C is employed by Employer X from May 15, 2015, through December 31, 2015. In addition, Employer X offers Employee C and her dependents minimum essential coverage during the period from August 1, 2015, through December 31, 2015, that provides minimum value. The employee contribution for self-only coverage is $100 per calendar month, or $500 for Employee C's period of employment.
>
> For 2015, Employee C's Form W-2 wages with respect to employment with Employer X are $15,000. For purposes of applying the affordability safe harbor, the Form W-2 wages are multiplied by 5/8 (5 calendar months of coverage offered over 8 months of employment during the calendar year). Accordingly, affordability is determined by comparing the adjusted Form W-2 wages ($9,375 or $15,000 x 5/8) to the employee contribution for the period for which coverage was offered ($500).
>
> (ii) Conclusion. Because the employee contribution of $500 is less than 9.5 percent of $9,375 (Employee C's adjusted Form W-2 wages for 2015), the coverage offered is treated as affordable with respect to Employee C for 2015 ($500 is 5.33 percent of $9,375).
>
> Example 4 (Rate of pay safe harbor). (i) Facts. Employer W offers its full-time employees and their dependents minimum essential coverage that provides minimum value. For the 2016 calendar year, Employer W is using the rate of pay safe harbor to establish premium contribution amounts for full-

time employees paid at a rate of $7.25 per hour (the minimum wage in Employer W's jurisdiction) for each calendar month of the entire 2016 calendar year.

Employer W can apply the affordability safe harbor by using an assumed monthly income amount that is based on an assumed 130 hours of service multiplied by $7.25 per hour ($942.50 per calendar month). To satisfy the safe harbor, Employer W would set the employee monthly contribution amount at a rate that does not exceed 9.5 percent of the assumed monthly income of $942.50. Employer W sets the employee contribution for self-only coverage at $85 per calendar month for 2016.

(ii) Conclusion. Because $85 is less than 9.5 percent of the employee's assumed monthly income at a $7.25 rate of pay, the coverage offered is treated as affordable under the rate of pay safe harbor for each calendar month of 2016 ($85 is 9.01 percent of $942.50).

<u>Example 5 (Rate of pay safe harbor).</u> (i) Facts. Employee E is employed by Employer V from May 1, 2015, through December 31, 2015. Employer V offers Employee E and her dependents minimum essential coverage from May 1, 2015, through December 31, 2015, that provides minimum value. The employee contribution for self-only coverage is $100 per calendar month.

From May 1, 2015, through October 31, 2015, Employee E is paid at a rate of $10 per hour. From November 1, 2015, through December 31, 2015, Employee E is paid at a rate of $12 per hour. For purposes of applying the affordability safe harbor for the calendar months May 2015 through October 2015, Employer V may assume that Employee E earned $1,300 per calendar month (130 hours of service multiplied by $10 (which is the lower of the employee's hourly rate of pay at the beginning of the coverage period ($10) and the lowest hourly rate of pay for the calendar month ($10)).

Accordingly, affordability is determined by comparing the assumed income ($1,300 per month) to the employee contribution ($100 per calendar month). For the calendar months November 2015 through December 2015, Employer V may assume that Employee E earned $1,300 per calendar month (130 hours of service multiplied by $10 (which is the lower of the employee's hourly rate of pay at the beginning of the coverage period ($10) and the lowest hourly rate of pay for the calendar month ($12)). Accordingly, affordability is determined by comparing the assumed income ($1,300 per month) to the employee contribution ($100 per calendar month).

(ii) Conclusion. Because $100 is less than 9.5 percent of Employee E's assumed monthly income for each calendar month from May 2015 through December 2015, the coverage offered is treated as affordable with respect to Employee E for May 2015 through December 2015 ($100 is 7.69 percent of $1,300).

<u>Example 6 (Federal poverty line safe harbor).</u> (i) Facts. Employee F is employed by Employer T from January 1, 2015, through December 31, 2015. In addition, Employer T offers Employee F and his dependents minimum essential coverage during that period that provides minimum value. Employer T uses the lookback measurement method. Under that measurement method as applied by Employer T, Employee F is treated as a full-time employee for the entire calendar year 2015.

Employee F is regularly credited with 35 hours of service per week but is credited with only 20 hours of service during the month of March 2015 and only 15 hours of service during the month of August 2015. Assume for this purpose that the federal poverty line for 2015 for an individual is $11,670. With respect to Employee F, Employer T sets the monthly employee contribution for employee single-only coverage for each calendar month of 2015 at $92.39 (9.5 percent of $11,670, divided by 12).

(ii) Conclusion. Regardless of Employee F's actual wages for any calendar month in 2015, including the months of March 2015 and August 2015, when Employee F has lower wages because of significantly lower hours of service, the coverage under the plan is treated as affordable with respect to Employee F, because the employee contribution does not exceed 9.5 percent of the federal poverty line.

2015 Transition Rules

Special rules are provided for issues related to non-calendar year plans and the provision of minimum value.

General Non-Calendar Year Plan Transition Rules

This relief provisions applies only to employers who maintained a non-calendar year plan as of December 27, 2013 and who have not modified the plan after that date to have it begin at a later calendar date. In such a case, the rule will apply to employees who would be eligible for coverage on the first day of the 2015 plan year under the terms of the plan as they existed on February 4, 2014.

If all of the above hurdles are cleared, no penalty will be assessed under §4980H for the employee for periods prior to the beginning of 2015 plan year so long as the employee is offered affordable coverage that provides minimum value no later than the first day of the 2015 plan year.

If the employee terminates employment before the first day of the 2015 plan year (and thus is never actually offered qualifying coverage), the relief will apply if the employee would have been eligible except for the fact that they were no longer employed on the first day of the 2015 plan year. [Explanation and Summary of Comments, Section XV.D.1.a]

Note that the employer may still be subject to a penalty for failure to offer to the proper percentage as of the first day of the plan year.

The IRS provides the following example of applying this rule:

As an illustration of the application of this rule, assume Employer Z has 600 employees, all of whom are full-time employees within the meaning of the final regulations, and Employer Z maintained a plan with an April 1 plan year as of December 27, 2012 (Plan P). Plan P's plan year was not modified after December 27, 2012, and all of Employer Z's employees are eligible for coverage under Plan P under the eligibility terms as in effect on February 9, 2014, however coverage offered prior to the 2015 plan year is not affordable.

All of Employer Z's employees are offered affordable coverage that provides MV effective no later than April 1, 2015. In this case, no section 4980H assessable payment will be due with respect to any employee of Employer Z for the period before April 1, 2015.

The same transition relief would apply to those 600 employees even if Employer Z also had a calendar year plan (Plan Q) and had a total of 1,000 full-time employees, 600 of whom were

> described above (and were not eligible for coverage under Plan Q) and 400 of whom were eligible for coverage under Plan Q as of January 1, 2015.
>
> However, the same transition relief would not apply to those 600 employees if as of April 1, 2015, the 400 other employees were not offered coverage (because as of that date Employer Z would not have offered coverage to all but five percent (or, if greater, five) of its full-time employees (and their dependents)) (and if the transition relief set forth in section XV.D.7 of this preamble applied, as of that date Employer Z would not have offered coverage to all but 30 percent of its full-time employees (and their dependents)).

<u>Significant Percentage Guidance (All Employees)</u>

This rule applies to non-calendar year plans in existence on December 27, 2012 for which the plan year was not modified after December 27, 2012 to begin at a later calendar date that either:

- As of any date in the 12 months ending on February 9, 2014 at least one quarter of its employees covered under such plans or

- Offered coverage to one third or more of its employees during the open enrollment period that ended most recently before February 9, 2014.

As with the above case which involved an employer with a single plan, in this case the affected employees will not be subject to a penalty if the tests are met.

In this case there are two caveats. To be excluded in those earlier months the employee:

- Must be offered affordable coverage that provides minimum value no later than the first day of the 2015 plan year and

- The employee was not eligible for coverage under any group health plan maintained by the employer that has a calendar year

The latter restriction would catch a situation where the employee could have moved to a calendar year plan which had unaffordable coverage on January 1. Obviously if they were eligible for and offered coverage under an affordable plan on January 1 there would be no need for any relief.

In this case the IRS offers a more detailed example in the preamble:

> For example, assume Employer Y has 1,100 employees. One thousand of Employer Y's employees are full-time employees and 100 of Employer Y's employees are not full-time employees. Employer Y maintained a plan with a July 1 plan year (Plan M) as of December 27, 2012. Plan M's plan year was not modified after December 27, 2012, to begin at a later calendar date. Employer Y does not offer any coverage other than Plan M.
>
> For purposes of applying the significant percentage transition guidance (all employees), Employer Y chooses December 1, 2013, as the date in the 12 months ending on February 9, 2014, to measure the number of employees it covered under Plan M. On December 1, 2013, Plan M covered 23 percent of Employer Y's employees (253 out of 1,100). During the open enrollment period that ended most

recently before February 9, 2014, Employer Y offered coverage under Plan M to 45 percent of its employees (495 out of 1,100). As of the first day of the 2015 plan year (July 1, 2015), Employer Y offers affordable coverage that provides MV under Plan M to all full-time employees. Employer Y does not offer coverage to employees who are not full-time employees.

Under the significant percentage transition guidance (all employees), no section 4980H assessable payment will be due with respect to any of the full-time employees of Employer Y for the period before July 1, 2015, because Employer Y offered coverage to 45 percent (which exceeds one third) of its employees during the open enrollment period that ended most recently before February 9, 2014, and the full-time employees of Employer Y are offered affordable coverage that provides MV no later than the first day of the 2015 plan year (July 1, 2015).

Relief is not provided under the significant percentage transition guidance (all employees) with respect to the 100 employees who are not full-time employees and to whom coverage is not offered as of July 1, 2015, but no relief is necessary for these employees because an employer is not liable for an assessable payment under section 4980H for failure to offer coverage to an employee who is not a full-time employee; however, nothing in section 4980H precludes an employer from providing coverage to employees who are not full-time employees.

Significant Percentage Guidance (Full-Time Employees)

Comments received on the proposed regulations complained that the prior significant percentage rule, since it counted total employees, would cause employers with large numbers of seasonal and part-time employees to be unable to make use of the rule. This would be true even though those employees would not be subject to the requirements to be offered coverage.

To address this issue, the IRS created a second significant percentage test that is limited to full-time employees only. Again, if the tests are met, no penalty will due for the employee for any months prior to the start of the 2015 plan year. [Explanation and Summary of Comments, Section XV.D.1c]

The basic requirements are the same as is true for the "all employees" test, but with higher percentage required. To be eligible the plan must be a non-calendar year plans in existence on December 27, 2012 for which the plan year was not modified after December 27, 2012 to begin at a later calendar date that either:

- As of any date in the 12 months ending on February 9, 2014 at least one third of its full-time employees covered under such plans or
- Offered coverage to one half or more of its full-time employees during the open enrollment period that ended most recently before February 9, 2014.

The same basic "offer" rules also apply. To be excluded in those earlier months the employee:

- Must be offered affordable coverage that provides minimum value no later than the first day of the 2015 plan year and
- The employee was not eligible for coverage under any group health plan maintained by the employer that has a calendar year

The IRS provides an example of the application of the full-time employee rule as follows:

> For example, assume Employer W has 2,000 employees, of whom 500 are fulltime employees and 1,500 are not full-time employees. Employer W maintained a plan with a July 1 plan year (Plan N) as of December 27, 2012. Plan N's plan year was not modified after December 27, 2012. Employer W does not offer any coverage other than Plan N.
>
> For purposes of applying the significant percentage transition guidance (full-time employees), Employer W chooses December 1, 2013, as the date in the 12 months ending on February 9, 2014, to count the number of full-time employees it covered under Plan N. On December 1, 2013, Plan N covered 20 percent of Employer W's fulltime employees (100 of 500).
>
> During the open enrollment period that ended most recently before February 9, 2014, Employer W offered coverage under Plan N to 60 percent of its full-time employees (that is, 300 of 500). As of the first day of the 2015 plan year (July 1, 2015), Employer W offers affordable coverage that provides MV under Plan N to all full-time employees. Employer W does not offer coverage to employees who are not full-time employees.
>
> Under the significant percentage transition guidance (full-time employees), no section 4980H assessable payment will be due with respect to Employer W's full-time employees for the period before July 1, 2015, because Employer W offered coverage to at least one half of its full-time employees during the open enrollment period that ended most recently before February 9, 2014, and the full-time employees of Employer W are offered affordable coverage that provides MV no later than the first day of the 2015 plan year (July 1, 2015).
>
> Relief is not provided under the significant percentage transition guidance (fulltime employees) with respect to Employer W's employees that are not full-time employees, but no relief is necessary for these employees because an employer is not liable for an assessable payment under section 4980H for failure to offer coverage to an employee who is not a full-time employee; however, nothing in section 4980H precludes an employer from providing coverage to employees who are not full-time employees.

Full Time Employee

A full-time employee is an employee who was, for the month, has 30 hours of service per week [IRC §4980H(c)(4)]. An employer is allowed to use a special equivalency rule, in lieu of a per week rule, that will count 130 hours of service per month as equal to 30 hours of service per week. An employer using the equivalency rule must do so on a reasonable and consistent basis. [Reg. §54-4980H-1(a)(21)]

If the employer is using the monthly measurement period above, the employer can use a weekly method that begins on the first day of the week that includes the first day of the month (but does not include the week that includes the last day of the month unless that day is the last day of the week) or a weekly method that begins on the first day of the week subsequent to the week that includes the first day of the month (this time including the week that contains the last day of the month) but does include the week of the first day of the month if that is the first day of that week. [Reg. §54.4980H-3(c)(3)]

If using the optional weekly method above, the hours equivalent to a full-time employee will be different depending on whether there are four or five weeks in the month. If there are four weeks, an employee will be full time if the employee has at least 120 hours that month, while if there are five weeks in the month an employee will be full time if they have 150 hours in that month. [Reg. §54.4980H-1(a)(21)(iii)]

Note that "FTEs" don't enter into the calculation of full-time employees for penalty purposes, despite being included in the determination of whether an employer will be covered for a year by looking at the prior year to compute the "50 employee" trigger. Similarly, the special "look-back" rules that are used for determining full-time employee status cannot be used for purposes of the prior year 50 employee test. [Reg. §54.4980H-3(a)]

Thus, it is theoretically possible for an employer to have more than 50 employees in the prior year but less than 30 full-time employees even if nothing had changed compared to the prior year. In such a case, the employer would never be subject to a penalty (as even if offering no coverage total full time employees would always be "written down" to zero by the "subtract 30" rule) but would nevertheless still be subject to the various reporting rules.

Hour of Service

The rules for determining a full-time employee look at hours of service, which is not the same as hours worked. An hour of service is defined as "is paid, or entitled to payment, for the performance of duties for the employer; and each hour for which an employee is paid, or entitled to payment by the employer for a period of time during which no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence (as defined in 29 CFR 2530.200b-2 (a))." [Reg. §54.4980H-1(a)(24)(i)]

Thus, paid time off must be counted as an hour of service, but unpaid time off would not be counted under these rules.

An hour of service as a bona fide volunteer does not count as an hour of service. [Reg. §54.4980H-1(a)(24)(ii)(A)] A bona fide volunteer is an employee of a government entity or §501(c) exempt organization whose only compensation from the entity is in the form of a reimbursement or reasonable allowance for expenses incurred in performing services as a volunteer or reasonable benefits (including length of service awards) and nominal fees customarily paid by similar entities in connection with the performance of services by volunteers. [Reg. §54.4980H-1(a)(7)]

Similarly, an hour of service performed as part of a Federal Work-Study Program (as defined in 34 CFR 675) or substantially similar program of a State or political subdivision of a State is not considered an hour of service for these purposes. [Reg. §54.4980H-1(a)(24)(ii)(B)] However hours of a paid intern outside of these programs would be considered an hour of service. [Explanation and Summary of Comments, Section VI.B.2]

Services performed outside the United States to the extent the compensation for the services constitutes income from sources without the United States (as defined by IRC §§861 through 863) are also not considered in counting hours of service. [Reg. §54.4980H-1(a)(24)(ii)(C)]

All hours of service for related employers must be combined in making this determination. Such an applicable large employer group is determined using the rules of IRC §414(b),(c),(m) and (o).

Determining Hours

For employees that are paid by the hour, the actual number of hours of service by the employee must be computed from the employer's records. [Reg. §54-4980H-3(b)(2)]

For employees that aren't paid on an hourly basis provides for a choice among three methods.

- Actual hours of service from the employer's records, including both hours actually worked and those for which payment is made or is due ("actual hours" rule)

- Using a "days worked" method that gives the employee 8 hours of service for each day on which the employee would be required to be credited with at least one hour of service under the actual hours rule

- Using a "weeks worked" method that give the employee credit for 40 hours of service for each week on which the employee would be required to be credited with at least one hour of service under the actual hours rule.

The employer must use one of these three methods to compute hours of service for non-hourly employees. Different methods may be used for different classifications of non-hourly employees so long as the classifications are reasonable and consistently applied. [Reg. §54.4980H-3(b)(2)]

However the regulations contain an anti-abuse rule—an employer may not use an equivalency method if it has the effect of substantially understating the number of hours worked by the employee in a manner that would cause the employee to not be treated as full-time.

As well, this method cannot be used for purposes of determining FTEs under the provisions testing for whether an employer is an "applicable large employer" based on the prior year if it would have the effect of understating the hours of a large number of employees even if it would not affect the classification of any single employee as full-time. [Reg. §54.4980H-3(b)(3)(iii)]

The regulations specifically "call out" using the days worked method for an employee that generally works 10 hours a day three days a week. [Reg. §54-4980H-3(b)(2)(iii)] Effectively, that's an example of a "disallowed" method even though it only missed 6 hours—but those six hours made the difference between counting and not counting.

Hopefully the IRS will not simply look at whether the "real" hours would make any person, for any particular month, a full-time employee when the alternative methods do not, but rather look for a "design" (such as setting up the employee to be sure they complete all work in 3 days or less each week to compress down to an assumed 24 hours) that is being used to insure an employee could not become a full-time employee even though, clearly, the employer expects more than 30 hours of service each week.

The preamble to the final regulations provide a discussion of dealing with "difficult" employment relationships for these hour of service rules. The regulations reserve these areas for future guidance, but the preamble provides provisions that can be used in the interim.

Adjunct Faculty

One category of "difficult to track hours" employees is adjunct faculty members of an educational institution that are paid on per course basis. Until further guidance is issued, employer are to use a reasonable method to estimate the hours of such individuals. The IRS specifically provided that one (but not the only) reasonable method would be to use 2.25 hours per teaching hours per week as a multiplier to take into account "out of classroom" time along with additional hours for any additional time outside the classroom the employee spends duties he/she is required to perform (such as office hours or attendance at faculty meetings). [Explanation and Summary of Comments, Section VI.C.1]

The IRS provides that this method will be valid at least for 2015 and in no event will this method no longer be allowed any earlier than January 1 of the calendar year beginning at least six months after the issuance of new guidance.

Layover Hours in the Airline Industry

Pilots and flight attendants are often required to stay overnight at locations other than their residence. Until guidance is issued, an employer is required to use a "reasonable basis" in crediting an employee for layover hours. [Explanation and Summary of Comments, Section VI.C.2]

However, the IRS holds that it is not reasonable for an employee to fail to credit an employee with hours of service if the employee receives compensation for the layover in addition to what the employee would receive without regard to the layover. As well, it would not be reasonable to not credit hours of service if the layover is counted by the employer towards hours of service required by the employee to earn his/her compensation.

If the employee is neither compensated an additional amount for the layover nor are the hours counted towards hours of service required to earn compensation, the IRS provides a safe harbor. For these cases, it would be reasonable to credit the employee with a minimum of 8 hours of service for each day the employee is required to stay away from home.

If the eight hour rule substantially understates the employee's actual hours of service for the day, though, it cannot be used. As well, the IRS makes clear that under this rule an employee would end up with a minimum of 16 hours with an overnight stay (eight hours for each day involved).

On-call Hours

Another difficult to measure area identified by the IRS involved employees who are required to be "on-call" and available for work. Again, a "reasonable method" must be used to credit the employee with hours in this case. Explanation and Summary of Comments, Section VI.C.3]

As with the airline employees, the IRS specifically holds that it would not reasonable to fail to credit an employee for an hour that the employee is actually compensated for.

As well, the IRS identifies two additional time periods that must be included for on-call employees even if compensation is not paid. These are:

- Periods where the employee is required to remain on the employer's premises while on-call and

- Periods in which the employee's activities while on-call are so restricted to prevent the employee from using the time effectively for the employee's purposes

In this case the IRS did not provide any sort of additional set of "safe harbor" guidance.

Look-Back Measurements for Continuing Employees

The IRS has allowed a "look-back" method to determine if a variable hour employee is full-time employee rather than having to only find out if the employee is full-time after a month has been completed. In this case, the employer will make a determination based on prior periods if an employee is or is not a full-time employee, and then use that determination for some time period in the future.

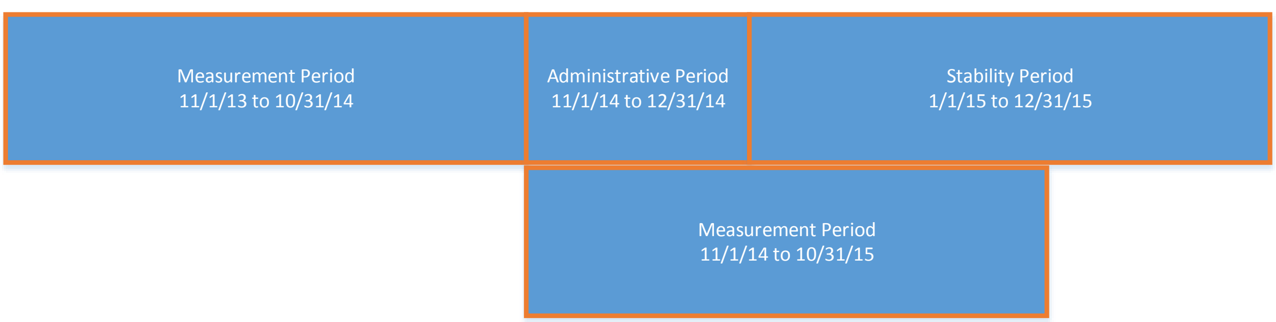
In such a case, in the follow-up period the employee will be treated as being full-time or not full-time regardless of the actual hours of the service the employee incurs during the months in question.

The IRS makes use of the following terms that are used in describing the method.

- Standard measurement period – this is the period that the employer will be using to make the determination of full-time status for a future period [Reg. §54.4980H-1(a)(40)]

- Stability period – the future period, following the "standard measurement period," during which an employee's status as full-time or not will be determined by the results of the standard measurement period [Reg. §54.4980H-1(a)(39)]

- Administrative period – an optional time period an employer may build into their look back system that will run from the end of the standard measurement period until the beginning of the stability period [Reg. §54.4980H-3(c)(1)]



Standard Measurement Period

The standard measurement is selected by the employer, but it must be at least three but no more than twelve consecutive months. [Reg. §54.4980H-1(a)(40)] The employer can select when the period will begin and end so long as it is done in a reasonable and consistent fashion. [Reg. §54.4980H-3(c)(1)]

The preamble to the final regulations provide that an employer may adopt a "one time" transitional measurement period for purposes of stability periods beginning in 2015. [Explanation and Summary of Comments, Section XV.D.2] This special period must be no less than 6 months, no longer than 12 months, begin no later than July 1, 2014 and end no earlier than 90 days before the first day of the plan year beginning on or after January 1, 2015.

The IRS provides examples of allowable transitional measurement periods.

> For example, an employer with a calendar year plan may use a measurement period from April 15, 2014, through October 14, 2014 (six months), followed by an administrative period ending on December 31, 2014.
>
> As a further example, an employer with a plan year beginning April 1 that also elected to implement a 90-day administrative period may use a measurement period from July 1, 2014, through December 31, 2014 (six months), followed by an administrative period ending on March 31, 2015.
>
> However, an employer with a plan year beginning on July 1 must use a measurement period that is longer than 6 months to comply with the requirement that the measurement period begin no later than July 1, 2014, and end no earlier than 90 days before the stability period.
>
> For example, the employer may have a 10-month measurement period from June 15, 2014, through April 14, 2015, followed by an administrative period from April 15, 2015, through June 30, 2015.

The transitional measurement period applies only to individuals who are employees on the day the transitional measurement period begins. Employees hired after that date are treated under the new employee rules.

The employer at this point will determine the number of hours of service the employee has during the standard measurement period. As was noted earlier, for hourly employees this would be the actual hours of service per the employer's records while the employer would use one of the three measuring methods described earlier for the non-hourly employees.

The employer then calculates whether the employee averaged 30 hours per week during this standard measurement period. If the employee did attain the 30 hour mark, the employer will treat the employee as a full-time employee for the following stability period. [Reg. §54.4980H-3(c)(1)]

The employer can begin and end the period on the start and end dates of standard one week, two week or semi-monthly payroll periods so long it treats the beginning date as the first day of the first payroll period that begins in the standard measurement period and the end date is the end of the final payroll that ends before the end of the standard measurement period. [Reg. §54.4980H-3(c)(1)(ii)]

<u>Stability Period</u>

If the employee is determined to have met the 30 hour threshold in the immediately preceding stability period, the employee must be treated as a full-time employee period for the entire stability period. The stability for this employee must be at least six months but no <u>shorter</u> than the standard measurement period. [Reg. §54.4980H-3(c)(1)(iii)]

If the employee is determined to have had less than, on average, 30 hours of service per week during the standard measurement period, the employee is excluded from treatment as a full-time employee during the stability period. This stability period has no minimum length, but can be no <u>longer</u> than the standard measurement period. [Reg. §54.4980H-3(c)(1)(iv)]

Given the above combination of required minimum and maximum periods, administrative convenience suggests that the employer may wish to adopt a single stability period that is equal to a standard measurement period, and that such standard measurement period should be at least six months long.

A change in the employee's position of employment or other employment status that would raise or lower his expected hours of employee will not change that employee's status during the stability period. [Reg. §54.4980H-3(c)(1)(vii)]

If a special 2015 transitional measurement period as provided for in the preamble to the final regulations and described earlier is used, that period will govern the stability period beginning in 2015 through the end of that stability. That is true even if a portion of that stability period falls in 2016. [Explanation and Summary of Comments, Section XV.D.2]

Optional Administrative Period

An employer may elect to impose an administrative period following the standard measurement period before the start of the stability period. Such a period can be no longer than 90 days and, to prevent a lapse in coverage, must overlap with the prior stability period. [Reg. §54.4980H-3(c)(1)(vi)]

So, for instance, an employer could adopt a standard measurement period from November 1 to October 31, a calendar year stability period and an optional administrative period from November 1 to December 31. The administrative period would allow the employer to compile the results of the standard measurement period, notify employees of their status and then handle any necessary enrollments.

Categorizing Employees

Under the regulations an employer is allowed to have different periods for various categories of employees. The periods may differ in their length as well as starting and ending dates.

The regulations allow for the following categories of employees to qualify for differing treatment:

- Collectively bargained employees and non-collectively bargained employees.
- Each group of collectively bargained employees covered by a separate collective bargaining agreement.
- Salaried employees and hourly employees.
- Employees whose primary places of employment are in different States.

Note that, unlike many other similar provisions in various regulations related to employees, there is no option for other "reasonable" classifications to be used. Only the categories specifically noted above are allowed to be broken out separately.

IRS Example of Application of Look-Back for Continuing Employees

The IRS provides the following detailed example of the application of these rules in Reg. §54.4980H-3(c)(1)(viii):

(i) Facts. Employer W is an applicable large employer member and computes hours of service following the rules in this section. Employer W chooses to use a 12-month stability period that begins January 1 and a 12-month standard measurement period that begins October 15.

Consistent with the terms of Employer W's group health plan, only employees classified as full-time employees using the look-back measurement method are eligible for coverage. Employer W chooses to use an administrative period between the end of the standard measurement period (October 14) and the beginning of the stability period (January 1) to determine which employees were employed on average 30 hours of service per week during the measurement period, notify them of their eligibility for the plan for the calendar year beginning on January 1 and of the coverage available under the plan, answer questions and collect materials from employees, and enroll those employees who elect coverage in the plan. Previously determined full-time employees already enrolled in coverage continue to be offered coverage through the administrative period.

Employee A and Employee B have been employed by Employer W for several years, continuously from their start date. Employee A was employed on average 30 hours of service per week during the standard measurement period that begins October 15, 2015 and ends October 14, 2016 and for all prior standard measurement periods.

Employee B also was employed on average 30 hours of service per week for all prior standard measurement periods, but is not a full-time employee during the standard measurement period that begins October 15, 2015 and ends October 14, 2016.

(ii) Conclusions. Because Employee A was employed for the entire standard measurement period that begins October 15, 2015 and ends October 14, 2016, Employee A is an ongoing employee with respect to the stability period running from January 1, 2017 through December 31, 2017.

Because Employee A was employed on average 30 hours of service per week during that standard measurement period, Employee A is offered coverage for the entire 2017 stability period (including the administrative period from October 15, 2017 through December 31, 2017).

Because Employee A was employed on average 30 hours of service per week during the prior standard measurement period, Employee A is offered coverage for the entire 2016 stability period and, if enrolled, would continue such coverage during the administrative period from October 15, 2016 through December 31, 2016.

Because Employee B was employed for the entire standard measurement period that begins October 15, 2015 and ends October 14, 2016, Employee B is also an ongoing employee with respect to the stability period in 2017.

Because Employee B did not work full-time during this standard measurement period, Employee B is not required to be offered coverage for the stability period in 2017 (including the administrative period from October 15, 2017 through December 31, 2017).

However, because Employee B was employed on average 30 hours of service per week during the prior standard measurement period, Employee B is offered coverage through the end of the 2016 stability period and, if enrolled, would continue such coverage during the administrative period from October 15, 2016 through December 31, 2016.

Employer W complies with the standards of paragraph (c)(1) of this section because the measurement and stability periods are no longer than 12 months, the stability period for ongoing employees who work fulltime during the standard measurement period is not shorter than the standard measurement period, the stability period for ongoing employees who do not work fulltime during the standard measurement period is no longer than the standard measurement period, and the administrative period is no longer than 90 days.

New Employees Treatment Under Look-Back Rules

The above is all well and good for continuing employees, but obviously it doesn't work for new hires who will have no prior standard measurement period to test. Thus a modified treatment is prescribed for new employees.

New Non-Variable Hour/Non-Seasonal Employees

If a new employee is hired who is reasonably expected to be a full-time employee at the time of hire, the employer will not be penalized for failing to offer coverage to that employee for the first three full calendar months so long as the employer offers such coverage as of the beginning of the fourth month. If the employer fails to offer coverage at that time, the employer may be subject to the §4980H payment on that employee for those first three months. [Reg. §54-4980H-3(d)(2)]

The determination is based on facts and circumstances at the employee's start date. Factors to consider identified in the regulations include:

- Whether the employee is replacing an employee who was (or was not) a full-time employee;
- The extent to which hours of service of ongoing employees in the same or comparable positions have varied above and below an average of 30 hours of service per week during recent measurement periods; and
- Whether the job was advertised, or otherwise communicated to the new hire or otherwise documented (for example, through a contract or job description), as requiring hours of service that would average 30 (or more) hours of service per week or less than 30 hours of service per week. [Reg. §54.4980H-3(d)(2)(ii)

An educational institution cannot consider the potential for, or likelihood of, an employment break in determining this status.

Initial Measurement Period for Other New Employees

A modified measurement period is used for new employees who either are variable hour or seasonal employees. This special period, which is subject to somewhat different rules than the standard measurement period, is called the "initial measurement period."

An employer defines an initial measurement period of at least three but no more than 12 consecutive months that will be used in lieu of the employer's standard measurement period. The initial measurement period for a new employee must start no later the beginning of the calendar month immediately following the employee's start date, but no earlier than the employee's start date. [Reg. §54.4980H-3(c)(3)(i)]

The employer measures the employee's hours during this period using the rules described earlier. If it is determined that the employee had, on average, at least 30 hours of service on average each week the employee is treated as a full time employee for a special stability period that begins immediately after the initial measurement period, but no shorter than the greater of six months or the initial measurement period. [Reg. §54.4980H-3(c)(3)(ii)]

If the employee is found to fall short of the 30 hour threshold, the employee will not be treated as a full-time employee for a period that must be no more than one month longer than the initial measurement period and no longer than the total of the remainder of the standard measurement period in which the initial measurement period ends plus any associated administrative period. [Reg. §54.4980H-3(c)(3)(iii)]

Special Administrative Period Rule

As is true for ongoing employees, an employer is allowed to apply an administrative period following the end of the initial measurement period before the initial stability period begins. However in this case the 90 day maximum is reduced day for day for each day following the employee's start date and when the initial measurement period begins, then again running following the end of initial measurement period until coverage is offered. [Reg. §54.4980H-3(c)(4)(v)(A)]

The IRS gives the following example of applying this rule:

> Thus, for example, if the applicable large employer member begins the initial measurement period on the first day of the first month following a new variable hour or new seasonal employee's start date, the period between the employee's start date and the first day of the next month must be taken into account in applying the 90-day limit on the administrative period. Similarly, if there is a period between the end of the initial measurement period and the date the employee is first offered coverage under the plan, that period must be taken into account in applying the 90-day limit on the administrative period.

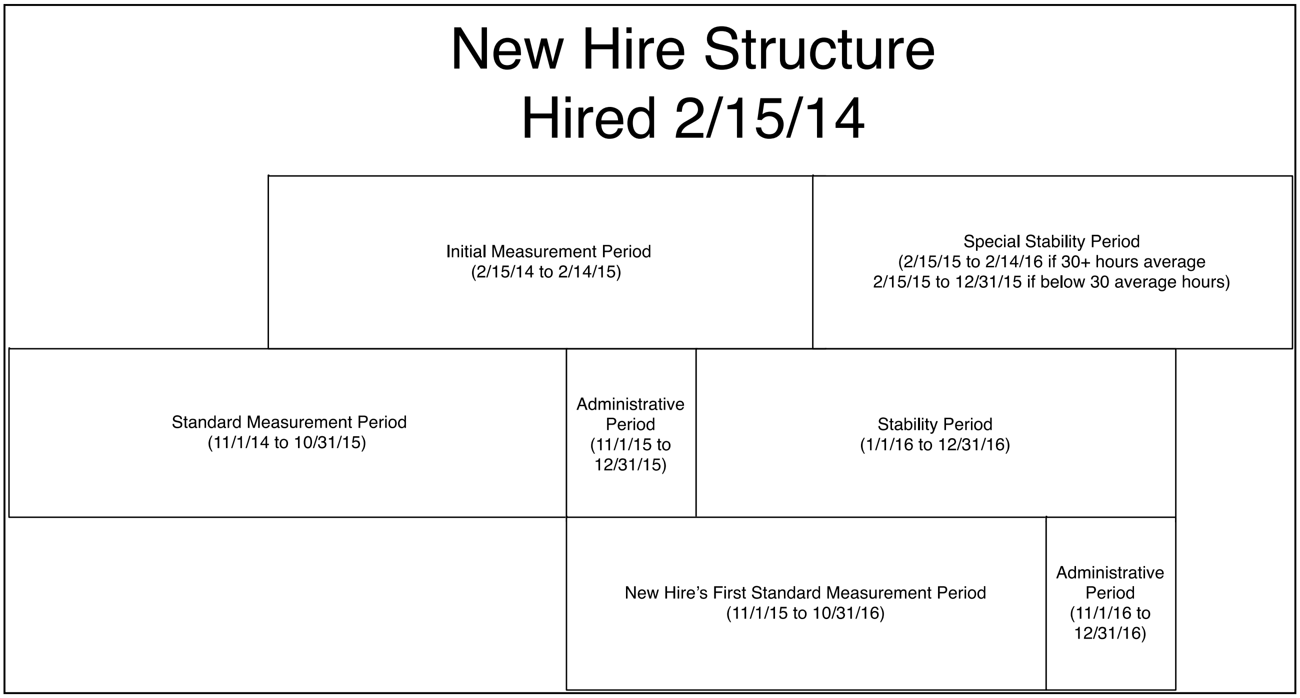
As well, the initial measurement plus any administrative period may not extend beyond the last date of the first calendar month beginning on or after the first anniversary of the employee's start date. [Reg. §54.4980H-3(c)(4)(v)(B)]

As the IRS notes:

> For example, if an applicable large employer member uses a 12-month initial measurement period for a new variable hour employee, and begins that initial measurement period on the first day of the first calendar month following the employee's start date, the period between the end of the initial measurement period and the offer of coverage to a new variable hour employee who works full time during the initial measurement period must not exceed one month.

Transitioning to Continuing Employee Tests

The employee is transitioned to continuing employee status once he/she has employed for a standard measurement period under the same rules as apply to the other ongoing employees. [Reg. §54.4980H-3(d)(4)(i)]



The IRS provides the following example of such a transition in Proposed Reg. §54.4980H-3(c)(4)(i):

> Accordingly, for example, an applicable large employer member with a calendar year standard measurement period that also uses a one-year initial measurement period beginning on the employee's start date would test a new employee whose start date is April 12 for full-time employee status first based on the initial measurement period (April 12 of the year including the start date through April 11 of the following year) and again based on the calendar year standard measurement period (if the employee continues in employment for that entire standard measurement period) beginning on January 1 of the year after the start date.

Note the overlap of the initial measurement period and the standard measurement period in the above example.

Even if an employee who cleared the 30 hour average in his/her initial measurement period is found to fail that test in the employee's first standard measurement period, the employee will still be treated as a full-time employee during the remainder of his/her "special" stability period. It does not matter if that overlaps with the ongoing employee's new stability period that is covered by this particular standard measurement period—in fact, it normally will overlap that period by design.

For instance, let us assume in the IRS example above that the employee met the full time test in the initial measurement test the employee will be treated as full-time for an entire year beginning on February 12 of the year after being hired. As well, let's assume the employer has no administrative period, thus the standard stability period begins on January 1 immediately following the end of the standard measurement period.

If the employee's hours drop below 30 hours in the standard measurement period, he/she will not be treated as no longer full-time until after February 12 of the subsequent regular stability period.

However in the opposite case where the employee is found to average less than 30 hours during the initial measurement period but clears the 30 hour hurdle during the first standard measurement period, the employee is treated as a full-time employee during the related stability period.

Thus, continuing with the IRS example let's assume this time the employee is found to average less than 30 hours during the initial measurement period, but exceeds 30 hours during the first standard measurement period. In that case, there is no delay in change of status until February 12—rather the employee will be immediately treated as a full-time employee as of the first day of the stability period (January 1 since we are assuming no administrative period).

If there is a gap between the stability period associated with the initial measurement period and the stability period associated with the employee's first full standard measurement period, the status of the employee as determined during the initial measurement period will apply during that gap. [Reg. §54.4980H-3(d)(4)(iv)]

IRS Comprehensive Examples for New Employees

The IRS provides the following examples of applying these new employee rules in Reg. §54.4980H-3(c)(5).

For all of these examples the IRS provides the following assumptions:

> In all of the following examples, the applicable large employer member has 200 full-time employees and offers all of its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan. The coverage is affordable within the meaning of section 36B(c)(2)(C)(i) (or is treated as affordable coverage under one of the affordability safe harbors described in §54.4980H-5) and provides minimum value.

The IRS provides the following additional facts that apply to the first eight examples:

> In Example 1 through Example 8, the new employee is a new variable hour employee, and the employer has chosen to use a 12-month standard measurement period for ongoing employees starting October 15 and a 12-month stability period associated with that standard measurement period starting January 1. (Thus, during the administrative period from October 15 through December 31 of each calendar year, the employer continues to offer coverage to employees who qualified for coverage for that entire calendar year based upon having an average of at least 30 hours of service per week during the prior standard measurement period.).

Thus, these are the first eight examples:

> Example 1 (12-Month initial measurement period followed by 1+ partial month administrative period).
> (i) Facts. For new variable hour employees, Employer Z uses a 12-month initial measurement period that begins on the start date and applies an administrative period from the end of the initial measurement period through the end of the first calendar month beginning on or after the end of the initial measurement period.
>
> Employer Z hires Employee A on May 10, 2015. Employee A's initial measurement period runs from May 10, 2015, through May 9, 2016. Employee A has an average of 30 hours of service per week during this initial measurement period. Employer Z offers coverage that provides minimum value to Employee A for a stability period that runs from July 1, 2016, through June 30, 2017.

For each calendar month during the period beginning with June 2015 and ending with June 2016, Employee A is otherwise eligible for an offer of coverage with respect to the coverage that is offered to Employee A on July 1, 2016.

(ii) Conclusion. Employer Z uses an initial measurement period that does not exceed 12 months; an administrative period totaling not more than 90 days; and a combined initial measurement period and administrative period that does not last beyond the final day of the first calendar month beginning on or after the one-year anniversary of Employee A's start date.

Accordingly, Employer Z complies with the standards for the initial measurement period and stability periods for a new variable hour employee. Employer Z will not be subject to an assessable payment under section 4980H(a) with respect to Employee A for any calendar month from June 2015 through June 2016 because, for each month during that period, Employee A is otherwise eligible for an offer of coverage and because coverage is offered no later than the end of the initial measurement period plus the associated administrative period (July 1, 2016).

Employer Z will not be subject to an assessable payment under section 4980H(b) with respect to Employee A for any calendar month from June 2015 through June 2016 because the coverage Employer Z offers to Employee A provides minimum value. Employer Z will not be subject to an assessable payment under section 4980H(a) or (b) with respect to Employee A for May 2015 because an applicable large employer member is not subject to an assessable payment under section 4980H with respect to an employee for the calendar month in which falls the employee's start date if the start date is on a date other than the first day of the calendar month.

Employer Z must test Employee A again based on the period from October 15, 2015, through October 14, 2016 (Employer Z's first standard measurement period that begins after Employee A's start date).

<u>Example 2 (11-Month initial measurement period followed by 2+ partial month administrative period).</u> (i) Facts. Same as Example 1, except that Employer Z uses an 11-month initial measurement period that begins on the start date and applies an administrative period from the end of the initial measurement period until the end of the second calendar month beginning after the end of the initial measurement period.

Employee A's initial measurement period runs from May 10, 2015, through April 9, 2016. The administrative period associated with Employee A's initial measurement period ends on June 30, 2016. Employee A has an average of 30 hours of service per week during this initial measurement period.

(ii) Conclusion. Same as Example 1.

<u>Example 3 (11-Month initial measurement period preceded by partial month administrative period and followed by 2-month administrative period).</u> (i) Facts. Same as Example 1, except that Employer Z uses an 11-month initial measurement period that begins on the first day of the first calendar month beginning after the start date and applies an administrative period that runs from the end of the initial measurement period through the end of the second calendar month beginning on or after the end of the initial measurement period.

Employee A's initial measurement period runs from June 1, 2015, through April 30, 2016. The administrative period associated with Employee A's initial measurement period ends on June 30, 2016. Employee A has an average of 30 hours of service per week during this initial measurement period.

(ii) Conclusion. Same as Example 1.

Example 4 (12-Month initial measurement period preceded by partial month administrative period and followed by 2-month administrative period). (i) Facts. For new variable hour employees, Employer Z uses a 12-month initial measurement period that begins on the first day of the first month following the start date and applies an administrative period that runs from the end of the initial measurement period through the end of the second calendar month beginning on or after the end of the initial measurement period. Employer Z hires Employee A on May 10, 2015.

Employee A's initial measurement period runs from June 1, 2015, through May 31, 2016. Employee A has an average of 30 hours of service per week during this initial measurement period. Employer Z offers coverage to Employee A for a stability period that runs from August 1, 2016, through July 31, 2017.

(ii) Conclusion. Employer Z does not satisfy the standards for the look-back measurement method in paragraph (d)(3)(vi)(B) of this section because the combination of the initial partial month delay, the 12-month initial measurement period, and the two month administrative period means that the coverage offered to Employee A does not become effective until after the first day of the second calendar month following the first anniversary of Employee A's start date.

Accordingly, Employer Z is potentially subject to an assessable payment under section 4980H for each full calendar month during the initial measurement period and associated administrative period.

Example 5(Continuous full-time employee). (i) Facts. Same as Example 1; in addition, Employer Z tests Employee A again based on Employee A's hours of service from October 15, 2015, through October 14, 2016 (Employer Z's first standard measurement period that begins after Employee A's start date), determines that Employee A has an average of 30 hours of service per week during that period, and offers Employee A coverage for July 1, 2017, through December 31, 2017. (Employee A already has an offer of coverage for the period of January 1, 2017, through June 30, 2017, because that period is covered by the initial stability period following the initial measurement period, during which Employee A was determined to be a full-time employee.)

(ii) Conclusion. Employer Z is not subject to any payment under section 4980H for any calendar month during 2017 with respect to Employee A.

Example 6 (Initially full-time employee, becomes non-full-time employee). (i) Facts. Same as Example 1; in addition, Employer Z tests Employee A again based on Employee A's hours of service from October 15, 2015, through October 14, 2016 (Employer Z's first standard measurement period that begins after Employee A's start date), and determines that Employee A has an average of 28 hours of service per week during that period.

Employer Z continues to offer coverage to Employee A through June 30, 2017 (the end of the stability period based on the initial measurement period during which Employee A was determined to be a full-time employee), but does not offer coverage to Employee A for the period of July 1, 2017, through December 31, 2017.

(ii) Conclusion. Employer Z is not subject to any payment under section 4980H for any calendar month during 2017 with respect to Employee A.

Example 7 (Initially non-full-time employee). (i) Facts. Same as Example 1, except that Employee A has an average of 28 hours of service per week during the initial measurement period (May 10, 2015, through May 9, 2016), and Employer Z does not offer coverage to Employee A for any calendar month in 2016.

(ii) Conclusion. From Employee A's start date through the end of 2016, Employer Z is not subject to any payment under section 4980H with respect to Employee A, because Employer Z complies with the standards for the measurement and stability periods for a new variable hour employee with respect to Employee A and because under those standards, Employee A is not a full-time employee for any month during 2016.

Example 8 (Initially non-full-time employee, becomes full-time employee). (i) Facts. Same as Example 7; in addition, Employer Z tests Employee A again based on Employee A's hours of service from October 15, 2015, through October 14, 2016 (Employer Z's first standard measurement period that begins after Employee A's start date), determines that Employee A has an average of 30 hours of service per week during this standard measurement period, and offers coverage to Employee A for 2017.

(ii)Conclusion. Employer Z is not subject to any payment under section 4980H for any calendar month during 2017 with respect to Employee A.

For the next two examples the IRS provides the following facts:

In Example 9 and Example 10, the new employee is a new variable hour employee, and the employer uses a six-month standard measurement period, starting each May 1 and November 1, with six-month stability periods associated with those standard measurement periods starting January 1 and July 1.

The next two IRS examples are reproduced below:

Example 9 (Initially full-time employee). (i) Facts. For new variable hour employees, Employer Y uses a six-month initial measurement period that begins on the start date and applies an administrative period that runs from the end of the initial measurement period through the end of the first full calendar month beginning after the end of the initial measurement period. Employer Y hires Employee B on May 10, 2015. Employee B's initial measurement period runs from May 10, 2015, through November 9, 2015, during which Employee B has an average of 30 hours of service per week.

Employer Y offers coverage that provides minimum value to Employee B for a stability period that runs from January 1, 2016, through June 30, 2016. For each calendar month during the period from June 2015 through December 2015, Employee B is otherwise eligible for an offer of coverage with respect to the coverage that is offered to Employee B on January 1, 2016.

(ii) Conclusion. Employer Y uses an initial measurement period that does not exceed 12 months; an administrative period totaling not more than 90 days; and a combined initial measurement period and administrative period that does not extend beyond the final day of the first calendar month beginning on or after the one-year anniversary of Employee B's start date. Employer Y complies with the standards for the measurement and stability periods for a new variable hour employee with respect to Employee B.

Employer Y is not subject to an assessable payment under section 4980H(a) with respect to Employee B for any calendar month from June 2015 through December 2015 because, for each month during that period, Employee B is otherwise eligible for an offer of coverage and because Employee B is offered coverage no later than the end of the initial measurement period plus the associated administrative period (January 1, 2016).

Employer Y is not subject to an assessable payment under section 4980H(b) with respect to Employee B for any calendar month from June 2015 through December 2015 because the coverage Employer Y offers to Employee B no later than January 1, 2016, provides minimum value. Employer Y is not subject to an assessable payment under section 4980H(a) or (b) with respect to Employee B for May 2015 because an applicable large employer member is not subject to an assessable payment under section 4980H with respect to an employee for the calendar month in which falls the employee's start date if the start date is on a date other than the first day of the calendar month.

Employer Y must test Employee B again based on Employee B's hours of service during the period from November 1, 2015, through April 30, 2016 (Employer Y's first standard measurement period that begins after Employee B's start date).

<u>Example 10 (Initially full-time employee, becomes non-full-time employee).</u> (i) Facts. Same as Example 9; in addition, Employer Y tests Employee B again based on Employee B's hours of service during the period from November 1, 2015, through April 30, 2016 (Employer Y's first standard measurement period that begins after Employee B's start date), during which period Employee B has an average of 28 hours of service per week.

Employer Y continues to offer coverage to Employee B through June 30, 2016 (the end of the initial stability period based on the initial measurement period during which Employee B has an average of 30 hours of service per week), but does not offer coverage to Employee B from July 1, 2016, through December 31, 2016.

(ii) Conclusion. Employer Y is not subject to any payment under section 4980H with respect to Employee B for any calendar month during 2016.

Finally the IRS provides examples for variable hour and seasonal employees.

<u>Example 11 (Seasonal employee, 12-month initial measurement period; 1+ partial month administrative period).</u> (i) Facts. Employer X offers health plan coverage only to full-time employees (and their dependents). Employer X uses a 12-month initial measurement period for new seasonal employees that begins on the start date and applies an administrative period from the end of the initial measurement period through the end of the first calendar month beginning after the end of the initial measurement period.

Employer X hires Employee C, a ski instructor, on November 15, 2015, with an anticipated season during which Employee C will work running through March 15, 2016. Employee C's initial measurement period runs from November 15, 2015, through November 14, 2016.

(ii) Conclusion. Employer X determines that Employee C is a seasonal employee because Employee C is hired into a position for which the customary annual employment is six months or less. Accordingly, Employer X may treat Employee C as a seasonal employee during the initial measurement period.

<u>Example 12 (Variable hour employee; temporary staffing firm).</u> (i) Facts. Employer W hires Employee D on January 1, 2015, in a position under which Employer W will offer assignments to Employee D to provide services in temporary placements at clients of Employer W, and employees of Employer W in the same position as Employee D, as part of their continuing employment, retain the right to reject an offer of placement.

Employees of Employer W in the same position of employment as Employee D typically perform services for a particular client for 40 hours of service per week for a period of less than 13 weeks, and for each employee there are typically periods in a calendar year during which Employer W does not have an assignment to offer the employee. At the time Employee D is hired by Employer W, Employer W has no reason to anticipate that Employee D's position of employment will differ from the typical employee in the same position.

(ii) Conclusion. Employer W cannot determine whether Employee D is reasonably expected to average at least 30 hours of service per week for the 12-month initial measurement period. Accordingly, Employer W may treat Employee D as a variable hour employee during the initial measurement period.

Example 13 (Variable hour employee; temporary staffing firm). (i) Facts. Employer V hires Employee E on January 1, 2015, in a position under which Employer V will offer assignments to Employee E to provide services in temporary placements at clients of Employer V. Employees of Employer V in the same position of employment as Employee E typically are offered assignments of varying hours of service per week (so that some weeks of the assignment typically result in more than 30 hours of service per week and other weeks of the assignment typically result in less than 30 hours of service per week).

Although a typical employee in the same position of employment as Employee E rarely fails to have an offer of an assignment for any period during the calendar year, employees of Employer V in the same position of employment, as part of their continuing employment, retain the right to reject an offer of placement, and typically refuse one or more offers of placement and do not perform services for periods ranging from four to twelve weeks during a calendar year.

At the time Employee E is hired by Employer V, Employer V has no reason to anticipate that Employee E's position of employment will differ from the typical employee in the same position.

(ii) Conclusion. Employer V cannot determine whether Employee E is reasonably expected to average at least 30 hours of service per week for the 12-month initial measurement period. Accordingly, Employer V may treat Employee E as a variable hour employee during the initial measurement period.

Example 14 (Variable hour employee; temporary staffing firm). (i) Facts. Employer T hires Employee F on January 1, 2015, in a position under which Employer T will offer assignments to Employee F to provide services in temporary placements at clients of Employer T. Employees of Employer T in the same position typically are offered assignments of 40 or more hours of service per week for periods expected to last for periods of three months to 12 months, subject to a request for renewal by the client.

Employees of Employer T in similar positions to Employee F are typically offered and take new positions immediately upon cessation of a placement. At the time Employee F is hired by Employer T, Employer T has no reason to anticipate that Employee F's position of employment will differ from the typical employee in the same position.

(ii) Conclusion. EmployerT must assume that Employee F will be employed by Employer T and available for an offer of temporary placement for the entire initial measurement period. Under that assumption, Employer T would reasonably determine that Employee F is reasonably expected to average at least 30 hours of service per week for the 12-month initial measurement period.

Accordingly, Employer T may not treat Employee F as a variable hour employee during the initial measurement period.

Example 15 (Variable hour employee). (i) Facts. Employee G is hired on an hourly basis by Employer S to fill in for employees who are absent and to provide additional staffing at peak times. Employer S expects that Employee G will average 30 hours of service per week or more for Employee G's first few months of employment, while assigned to a specific project, but also reasonably expects that the assignments will be of unpredictable duration, that there will be periods of unpredictable duration between assignments, that the hours per week required by subsequent assignments will vary, and that Employee G will not necessarily be available for all assignments.

(ii) Conclusion. Employer S cannot determine whether Employee G is reasonably expected to average at least 30 hours of service per week for the initial measurement period. Accordingly, Employer S may treat Employee G as a variable hour employee during the initial measurement period.

Example 15 (Variable hour employee). (i) Facts. Employee G is hired on an hourly basis by Employer S to fill in for employees who are absent and to provide additional staffing at peak times.

Employer S expects that Employee G will average 30 hours of service per week or more for Employee G's first few months of employment, while assigned to a specific project, but also reasonably expects that the assignments will be of unpredictable duration, that there will be periods of unpredictable duration between assignments, that the hours per week required by subsequent assignments will vary, and that Employee G will not necessarily be available for all assignments.

(ii) Conclusion. Employer S cannot determine whether Employee G is reasonably expected to average at least 30 hours of service per week for the initial measurement period. Accordingly, Employer S may treat Employee G as a variable hour employee during the initial measurement period.

Example 16 (Period between initial stability period and standard stability period). (i) Facts. Employer R uses an 11-month initial measurement period for new variable hour, new seasonal, and new part-time employees with an administrative period that lasts from the end of the initial measurement period through the last day of the first calendar month beginning on or after the first anniversary of the employee's start date. Employer R uses a standard measurement period of October 15 through October 14, and an administrative period of October 15 through December 31.

Employee H is hired as a variable hour employee on October 20, 2015, with an initial measurement period of October 20, 2015, through September 19, 2016, and an administrative period lasting through November 30, 2016. Employee H is a full-time employee based on the hours of service in the initial measurement period, and Employee H's stability period for the initial measurement period is December 1, 2016, through November 30, 2017.

Employee H's first full standard measurement period begins on October 15, 2016, with an associated stability period beginning on January 1, 2018. The standard measurement period beginning on October 15, 2015, does not apply to Employee H because Employee H is not hired until October 20, 2015.

(ii) Conclusion. For the period after the stability period associated with the initial measurement period and before the stability period associated with Employee H's first full standard measurement period (that is December 1, 2017, through December 31, 2017), Employer R must treat Employee H as a full-time employee because the treatment as a full-time employee (or not a full-time employee) that applies during the stability period associated with the initial measurement period continues to apply until the beginning of the stability period associated with the first full standard measurement period during which the employee is employed.

Rehired Employees

Sometimes employees leave and then return back to work with the same employer. The regulations have rules that cover this case, attempting to plug what the IRS apparently perceives might be an incentive to dismiss and rehire employees to restart waiting periods, thus keeping an employee from ever being subject to the §4980H penalty.

For employers who are not educational institutions a rehired employee will generally be treated like any new employee unless the employee did not have an hour of service for the employer for 13 weeks prior to the resumption of employment. [Reg. §54.4980H-3(d)(6)(i)] This will be true if the employee was formally terminated or simply is returning after an absence.

For entities that are educational institutions the 13 week period is extended to 26 weeks. [Reg. §54.4980H-3(d)(6)(ii)]

If the employee was not away long enough to be treated as a new hire, the employee will resume the same status he/she had immediately before the hours of service ceased with respect to any stability period. However, the employee will be treated as being offered coverage upon resumption of employee if is offered to the employee as of his/her first hour of service or, if later, as soon as is administratively practical. [Reg. §54.4980H-3(d)(6)(iii)]

Special rules apply if an organization applies the look-back measurement period to an employee not being treated as a new employee under these rules. Certain breaks in service must be ignored in computing the average number of hours for measurement periods.

Specifically employers must either ignore the following periods of absence or credit the employee with same average number of hours as during the period not considered "special leave":

- Unpaid FMLA Leave

- Unpaid leave subject to the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)

- Unpaid leave for jury duty [Reg. §54.4980H-1(a)(44), Reg. §54.4980H-3(6)(i)(B), (6)(ii)(B)]

Recall that if an employee is paid for the above hours, such would be considered an hour of service.

Educational institutions have a modified version of the above rules that adds to the list of "excluded" time an employment break of up to 501 hours (presumably to take into account "summer vacations" or similar breaks that occur for educational institutions). [Reg. §54.4980H-3(d)(6)(ii)(B)]

For purposes of determining a period during which an employee will be deemed to have terminated employment and having been rehired, an employer may choose a period (measured in weeks) of at least four consecutive weeks during which the employee is not credited with an hour of service. This number must be shorter than 13 weeks (26 weeks for an educational institution) and must exceed the number of weeks of that employee's employment with the employer immediately before the period in question. [Reg. §54.4980H-3(d)(6)(iv)]

If an employee is transferred to a position outside the United States (officially if "substantially all of the compensation will constitute income from outside the United States") that is expected to continue indefinitely or for at least 12 months, the employee can be treated as having terminated employment. [Reg. §54.4980H-3(d)(v)]

An anti-abuse rule requires the employee to ignore any service that exist due to the employer's request or requirement that the employee perform an hour of service during the periods noted above. The IRS notes: "For example, if an employee of an educational organization would otherwise have a period with no hours of service to which the rules under paragraph (d)(6)(ii)(B) of this section would apply, but for the employer's request or requirement that the employee perform one or more hours of service for a purpose of avoiding the application of those rules, any such hours of service for the week are disregarded, and the rules under paragraph (d)(6)(ii)(B) of this section will apply." [Reg. §54.4980-3(c)(4)(iv)]

The IRS provides the following four examples related to the "rehire" rules.

> All employers in these examples are applicable large employer members with 200 full-time employees (including full-time equivalent employees), each is in a different applicable large employer group, and each determines full-time employee status under the look-back measurement method. None of the periods during which an employee is not credited with an hour of service for an employer involve special unpaid leave or the employee being credited with hours of service for any applicable large employer member in the same applicable large employer as the employer.

Example 1. (i) Facts. As of April 1, 2015, Employee A has been an employee of Employer Z (which is not an educational organization) for 10 years. On April 1, 2015, Employee A terminates employment and is not credited with an hour of service until June 1, 2015, when Employer Z rehires Employee A and Employee A continues as an employee through December 31, 2015, which is the close of the measurement period as applied by Employer Z.

(ii) Conclusion. Because the period for which Employee A is not credited with any hours of service is not longer than Employee A's prior period of employment and is less than 13 weeks, Employee A is not treated as having terminated employment and been rehired for purposes of determining whether Employee A is treated as a new employee upon resumption of services.

Therefore, Employee A's hours of service prior to termination are required to be taken into account for purposes of the measurement period, and Employee A's period with no hours of service is taken into account as a period of zero hours of service during the measurement period.

Example 2. (i) Facts. Same facts as Example 1, except that Employee A is rehired on December 1, 2015.

(ii) Conclusion. Because the period during which Employee A is not credited with an hour of service for Employer Z exceeds 13 weeks, Employee A is treated as having terminated employment on April 1, 2015, and having been rehired as a new employee on December 1, 2015, for purposes of determining Employee A's full-time employee status.

Because Employee A is treated as a new employee, Employee A's hours of service prior to termination are not taken into account for purposes of the measurement period, and the period between termination and rehire with no hours of service is not taken into account in the new measurement period that begins after the employee is rehired.

Example 3. (i) Facts. Employee B is employed by Employer Y, an educational organization. Employee B is employed for 38 hours of service per week on average from September 7, 2014, through May 23, 2015, and then does not provide services (and is not otherwise credited with an hour of service) during the summer break when the school is generally not in session. Employee B resumes providing services for Employer Y on September 7, 2015, when the new school year begins.

(ii) Conclusion. Because the period from May 24, 2015 through September 5, 2015 (a total of 15 weeks), during which Employee B is not credited with an hour of service does not exceed 26 weeks, and also does not exceed the number of weeks of Employee B's immediately preceding period of employment, Employee B is not treated as having terminated employment on May 24, 2015, and having been rehired on September 6, 2015.

Also, for purposes of determining Employee B's average hours of service per week for the measurement period, Employee B is credited, under the averaging method for employment break periods applicable to educational organizations, as having an average of 38 hours of service per week for the 15 weeks between May 24, 2015 and September 5, 2015, during which Employee B otherwise was credited with no hours of service.

However, Employer Y is not required to credit more than 501 hours of service for the employment break period (15 weeks x 38 hours = 570 hours).

Example 4. (i) Facts. Same facts as Example 3, except that Employee B does not resume providing services for Employer Y until December 5, 2015.

(ii) Conclusion. Because the period from May 24, 2015 through December 5, 2015, exceeds 26 weeks, Employee B may be treated as having terminated employment on May 24, 2015, and having been rehired on December 5, 2015. Because Employee B is treated as a new employee on December 5, 2015, Employee B's hours of service prior to termination are not taken into account for purposes of the measurement period, and the period between termination and rehire with no hours of service is not taken into account in the new measurement period that begins after Employee B is rehired.

The averaging method for employment break periods applicable to educational organizations does not apply because Employee B is treated as a new employee rather than a continuing employee as of the date of resumption of services.

Change in Employment Status

Employees may change positions, and the new position may either have a more or less stable number of hours. The regulations provide rules for moving employees between the “monthly measurement period” (for stable hour employees) and the look-back measurement method (for variable hour employee).

Change from Look-Back to Monthly

If an employee’s status changes in such a way that if the employee had been hired for a new position where there is now a more stable expectation on hours (and thus the monthly measurement period would be used instead of the look-back method), special rules apply.

- If the employee is in a stability period under which the employee is treated as a full-time employee, the employer must continue to treat that employee as full-time for the remainder of the stability period [Reg. §54.4980H-3(f)(1)(A)]

- If the employee is in a stability period where the employee is not treated as full-time employee, the employer may continue to treat the employee as not a full-time employee through the end of the stability period *or* may apply the monthly measurement method through the end of the ability beginning with any calendar month (from the calendar month in which the change occurs or subsequent calendar month through the end of the stability period). [Reg. §54.4980H-3(f)(1)(i)(B)]

- For the stability period associated with the measurement period where the change in status occurs (that is, normally the *following* stability period) the employee must be treated as a full-time employee during any calendar month in which the employee would be treated as a full-time employee under *either*:

  - The new stability period that would have applied based on the measurement period when the change occurred *or*

  - The monthly measurement period in question[Reg. §54.4980H-3(f)(1)(i)(C)]

- Following the end of that following stability period, using only the monthly measurement method to determine full-time status. [Reg. §54.4980H-3(f)(1)(i)(D)]

The IRS has examples of the look-back to monthly transition situation. In each of the examples, the employer uses the monthly measurement method for determining whether a salaried employee is a full-time employee, and the look-back measurement method for determining whether an hourly employee is a full-time employee with a measurement period from October 15 through October 14 of the following calendar year, and a stability period from January 1 through December 31. In each case, the relevant employee has been employed continuously for several years.

> <u>Example 1 (Look-back measurement method to monthly measurement method).</u> Employee A is an hourly employee. Based on Employee A's hours of service from October 15, 2015, through October 14, 2016, Employee A is treated as a full-time employee from January 1, 2017, through December 31, 2017. On July 1, 2017, Employee A transfers from a position as an hourly employee to a position as a salaried employee.
>
> For the months July 2017 through December 2017, Employee A must be treated as a full-time employee. Employee A is employed for hours of service from October 15, 2016, through October 14, 2017, such that under the applicable look-back measurement method Employee A would be treated as a full-time employee for the period of January 1, 2018, through December 31, 2018.
>
> Accordingly, Employee A must be treated as a full-time employee for the calendar year 2018. For calendar year 2019, the determination of whether Employee A is a full-time employee is made under the monthly measurement method.
>
> <u>Example 2 (Look-back measurement method to monthly measurement method).</u> Same facts as Example 1, except that based on Employee A's hours of service from October 15, 2015, through October 14, 2016, Employee A is not treated as a full-time employee from January 1, 2017, through December 31, 2017.
>
> For the months July 2017 through December 2017, Employer Z may either treat Employee A as not a fulltime employee or apply the monthly measurement method to determine Employee A's status as a full-time employee. Employee A is employed for hours of service from October 15, 2016, through October 14, 2017, such that under the applicable look-back measurement method Employee A would be treated as a full-time employee for the period of January 1, 2018, through December 31, 2018.
>
> Employee A must be treated as a full-time employee for the calendar year 2018. For calendar year 2019, the determination of whether Employee A is a full-time employee is made under the monthly measurement method.
>
> <u>Example 3 (Look-back measurement method to monthly measurement method).</u> Same facts as Example 1, except that Employee A is employed for hours of service from October 15, 2016, through October 14, 2017, such that under the applicable look-back measurement method Employee A would not be treated as a full-time employee for the period of January 1, 2018, through December 31, 2018.
>
> For the calendar year 2018, Employer Z must treat Employee A as a full-time employee only for calendar months during which Employee A would be a full-time employee under the monthly

measurement method. For calendar year 2019, the determination of whether Employee A is a full-time employee is made under the monthly measurement method.

Change from Monthly to Look-Back

There are also rules in place for when an employee switches from a "stable" hours expectation to a variable status, converting form the monthly rule to the look back rule.

In this situation the following rules apply:

- For the remainder of the stability period during which the change takes place the employer must continue to use the monthly measurement method to determine the employee's "full-time" status each month. However, if the employee's hours of service prior to the change in employment would have resulted in the employee being treated as full-time during the current stability period the employee must be treated as full-time for the remainder of the stability period. [Reg. §54.4980H-3(f)(1)(ii)(A)]

- For the stability period following the measurement period in which the change in status occurs, the employer must treat the employee as a full-time employee for any calendar month during which the employee would be treated as a full-time employee using either:

    - The measurement period during the which the change in status took place *or*

    - The monthly measurement period for the month in question. [Reg. §54.4980H-3(f)(1)(ii)(B)]

- For any calendar month following the end of the stability period in the bullet point immediately above, the look-back measurement period applies for determining the employee's status. [Reg. §54.4980H-3(f)(1)(ii)(C)]

The IRS continues with their examples using the basic facts noted above, except this time with the employee transitioning to the look-back method.

Example 4 (Monthly measurement method to look-back measurement method). Employee B is a salaried employee of Employer Y. On July 1, 2017, Employee B transfers to an hourly employee position. Based on Employee B's hours of service from October 15, 2015, through October 14, 2016, Employee B would have been treated as a full-time employee for the stability period from January 1, 2017, through December 31, 2017, had the look-back measurement method applicable to hourly employees applied to Employee B for the entire stability period.

For the calendar months January 2017 through June 2017 (prior to Employee B's change to hourly employee status), Employee B's status as a full-time employee is determined using the monthly measurement method. For the calendar months July 2017 through December 2017, Employer Y must treat Employee B as a full-time employee because Employee B would have been treated as a full-time employee during that portion of the stability period had the look-back measurement method applied to Employee B for that entire stability period.

Employee B is employed for hours of service from October 15, 2016, through October 14, 2017, such that under the applicable look-back measurement method Employee B would be treated as a full-time employee for the period January 1, 2018, through December 31, 2018. Accordingly, Employee B must be treated as a full-time employee for the calendar year 2018.

For calendar year 2019, the determination of whether Employee B is a full-time employee is made under the applicable look-back measurement method.

Example 5 (Monthly measurement method to look-back measurement method). Same facts as Example 4, except that based on Employee B's hours of service from October 15, 2015, through October 14, 2016, Employee B would not have been treated as a full-time employee from January 1, 2017, through December 31, 2017.

For the calendar months of 2017, Employer Y applies the monthly measurement method to determine Employee B's status as a full-time employee. Employee B is employed for hours of service from October 15, 2016, through October 14, 2017, such that under the applicable look-back measurement method Employee B would be treated as a full-time employee for the period January 1, 2018, through December 31, 2018.

Accordingly, Employee B must be treated as a full-time employee for the calendar year 2018. For calendar year 2019, the determination of whether Employee B is a full-time employee is made under the applicable look-back measurement method.

Example 6 (Monthly measurement method to look-back measurement method). Same facts as Example 4, except that Employee B is employed for hours of service from October 15, 2016, through October 14, 2017, such that under the applicable look-back measurement method Employee B would not be treated as a full-time employee for the period of January 1, 2018, through December 31, 2018.

For the calendar year 2018, Employer Y must treat Employee B as a full-time employee only for calendar months during which Employee B would be a full-time employee under the monthly measurement method.

Employees to Whom Minimum Value Coverage Has Been Continually Offered

The above rules will not be required to apply in the case where the employee had been offered minimum value coverage continuously from the beginning of the first day of the calendar month following the employee's first three full months of employment.

In that case, an employer with an employee switching from a variable to a "less variable" position may have their full-time status determined almost as if they were a new hire by using the monthly method beginning with the first day of the calendar month following three full months of employment in the new position.

In this situation the employer may begin to test the employee using the monthly rule if the employee had begun employment in this new position or status, the employee would not have been reasonably been expected to have 30 hours of service per week on average. Up until the beginning of that month, the employee's status is based on his/her status during the applicable stability period(s).

The employer may use this option even if the employer does not use the monthly method for other employees in the same category of employees. The IRS specifically gives as an example that "an employer could apply the monthly measurement method to an hourly employee, even if the employer uses the look-back measurement method to determine full-time employee status of all other hourly employees." [Reg. §54-4980H-3(1)(f)(2)(i)]

The employer can continue to apply the monthly method through the end of the first full measurement period and any associated administrative period that would have applied had the employee stayed under the applicable look-back period.

The IRS provides two examples of applying this provision:

> Example 1 (New variable hour employee, no delay in coverage, becomes nonfull-time employee). (i) Facts. Employer Z, an applicable large employer, uses the look-back measurement method to determine the full-time employee status for all of its employees. On May 10, 2015, Employer Z hired Employee A who is a variable hour employee.
>
> Although Employee A is a new variable hour employee, so that Employer Z could wait until the end of an initial measurement period to offer coverage to Employee A without an assessable payment under section 4980H with respect to Employee A, Employer Z offers coverage that provides minimum value to Employee A on September 1, 2015.
>
> For its ongoing employees, Employer Z has chosen to use a 12-month standard measurement period starting October 15 and a 12-month stability period associated with that standard measurement period starting January 1. Employee A continues in employment with Employer Z for over five years and averages more than 30 hours of service per week for all measurement periods through the measurement period ending October 14, 2020.
>
> On February 12, 2021, Employee A experiences a change in position of employment with Employer Z to a position under which Employer Z reasonably expects Employee A to average less than 30 hours of service per week. For the calendar months after February 2021, Employee A averages less than 30 hours of service per week. Employer Z offered Employee A coverage that provided minimum value continuously from September 1, 2015, through May 31, 2021.
>
> Effective June 1, 2021, Employer Z elects to apply the monthly measurement method to determine Employee A's status as a full-time employee for the remainder of the stability period ending December 31, 2021, and the calendar year 2022 (which is through the end of the first full measurement period following the change in employment status plus the associated administrative period).
>
> Applying the stability period beginning January 1, 2021, Employer Z treats Employee A as a full-time employee for each calendar month from January 2021 through May 2021. Applying the monthly measurement method, for each calendar month from June 2021 through December 2022, Employer Z treats Employee A as not a full-time employee.
>
> (ii) Conclusion. Because Employer Z offered coverage that provided minimum value to Employee A from no later than the first day of the fourth full calendar month following Employee A's start date through the calendar month in which the change in employment status occurred, and because Employee A did not average 30 hours of service per week for any of the three calendar months immediately following Employee A's change in employment status to an employee not reasonably expected to average 30 hours of service per week, Employer Z may use the monthly measurement

method to determine the full-time employee status of Employee A beginning on the first day of the fourth month following the change in employment status (June 1, 2021) through the end of the first full measurement period (plus any associated administrative period) immediately following the change in employment status (December 31, 2022).

Because Employee A did not average at least 30 hours of service per week for any calendar month from June 2021 through December 2022, Employer Z has properly treated Employee A as not a full-time employee for those calendar months.

Example 2 (New full-time employee, no delay in coverage, becomes non-full-time employee). (i) Facts. Same facts as Example 1, except that at Employee A's start date, Employer Z reasonably expects that Employee A will average at least 30 hours of service per week. Accordingly, Employer Z offers coverage to Employee A beginning on September 1, 2015, and offers coverage continuously to Employee A for all calendar months through May 2021.

(ii) Conclusion. Same as Example 1.

Employee Nonpayment of Premiums

An employer will not be treated as failing to offer a full-time employee (and dependents) coverage if the employee fails to pay his/her required employee contribution to coverage, but only through the end of the coverage period (normally the plan year). [Reg. §54.4980H-3(f).

No Deduction Allowed for Shared Cost Payments

No income tax deduction shall be allowed for any payment made under this provision [§4980H(c)(6)]. Thus the cost to an employer of this provision will need to be compared with the after tax cost of offering benefits that would eliminate the liability for the payment to do a proper analysis.

LARGE EMPLOYER INFORMATION REPORTING REQUIREMENTS

Under the law as originally passed, beginning for years after December 31, 2013, employers potentially subject to the shared cost provisions of §4980H for its full time employees would be required to file an information reporting return with the IRS [§6056]. However, in July of 2013 the Treasury announced a one year delay in requiring employers to undertake such reporting. For now such reporting will first be required in 2014. [Article by Mark J. Mazur, Assistant Secretary for Tax Policy, Treasury Notes Blog, July 2, 2013]

The report will contain the name, address and EIN of the employer, a certification as to whether the employer offers its full-time employees (and their dependents) the opportunity to sign up for such coverage, the number of full-time employees for each month during the calendar year, the name, address and EIN of each employee and dependent that were covered under such a plan and other information the IRS may require [§6056(b)].

If the employer does offer its employees the right to enroll, additional information will be provided, including the length of any waiting period for coverage, the months during which coverage was available, the monthly premium cost of the lowest cost option in each of the categories under the plan, and the employer's share of costs of benefits under the plan.

If the required contribution of any employee exceed 8% of the wages paid to that employee, the employer will also report the option for which the employer pays the largest part of the costs and the portion of cost paid by the employee in each of the enrollment categories under the plan [§6056(b)(2)(C)].

The employer will also furnish a copy of the information provided to each person whom it reports upon by January 31 of the year following the calendar year [§6056(c)].

The final regulations on the shared responsibility payments [TD 9655] provided special guidance for sponsors of fiscal year plans taking advantage of the 2015 transitional guidance for such plans under the rules for offering coverage. Regardless of the fact that the employer will not be subjected to a §4980H penalty for a portion of the year for certain employees during the 2014 plan year that ends in 2015, IRC §6056 still requires reporting on those employees.

The transition rule provides that an employer may determine full-time employees for that period after the period has ended, using actual service data or the look-back measurement period (which may be running at the beginning of 2015 under the transitional rules for a fiscal-year plan). The employer will also be required to determine if the plan offered minimum value and the employee portion of the premium required. Additional guidance on handling this issue is promised to be contained in the return instructions for the information return under IRC §6056. [Explanation and Summary of Comments, Section XV.D.1.e]

FACTA and FBAR PROVISIONS

Advisers must keep in mind the special provisions that apply to reporting various foreign interests. Below we have summarized the various items that should be reported both on the Form 8938 on the tax return (FACTA) and Form 104 (previously Form TD F 90-22.1) electronically. To date the IRS has not released entity reporting provisions for FACTA via the Form 8938 or equivalent.

The text below is based on the IRS's table comparing reporting requirements under FACTA (Form 8938) and FBAR (now done electronically via Form 104):

	Form 8938, Statement of Specified Foreign Financial Assets	**Form TD F 90-22.1 (Now Form 104), Report of Foreign Bank and Financial Accounts (FBAR)**
Who Must File?	Specified individuals, which include U.S citizens, resident aliens, and certain non-resident aliens that have an interest in specified foreign financial assets and meet the reporting threshold	U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold
Does the United States include U.S. territories?	No	Yes, resident aliens of U.S territories and U.S. territory entities are subject to FBAR reporting

	Form 8938, Statement of Specified Foreign Financial Assets	Form TD F 90-22.1 (Now Form 104), Report of Foreign Bank and Financial Accounts (FBAR)
Reporting Threshold (Total Value of Assets)	$50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad)	$10,000 at any time during the calendar year
When do you have an interest in an account or asset?	If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on your income tax return	Financial interest: you are the owner of record or holder of legal title; the owner of record or holder of legal title is your agent or representative; you have a sufficient interest in the entity that is the owner of record or holder of legal title. Signature authority: you have authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account. See instructions for further details.
What is Reported?	Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign non-account investment assets	Maximum value of financial accounts maintained by a financial institution physically located in a foreign country
How are maximum account or asset values determined and reported?	Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported Convert to U.S. dollars using the end of the taxable year exchange rate and report in U.S. dollars.	Use periodic account statements to determine the maximum value in the currency of the account. Convert to U.S. dollars using the end of the calendar year exchange rate and report in U.S. dollars.
When Due?	By due date, including extension, if any, for income tax return	Received by June 30 (no extensions of time granted)
Where to File?	File with income tax return pursuant to instructions for filing the return	Electronically at BSA E-Filing System (no paper filing option after 7/1/13)
Penalties	Up to $10,000 for failure to disclose and an additional $10,000 for each 30 days of non-filing after IRS notice of a failure to disclose, for a potential maximum penalty of $60,000; criminal penalties may also apply	If non-willful, up to $10,000; if willful, up to the greater of $100,000 or 50 percent of account balances; criminal penalties may also apply
Types of Foreign Assets and Whether They are Reportable		

	Form 8938, Statement of Specified Foreign Financial Assets	Form TD F 90-22.1 (Now Form 104), Report of Foreign Bank and Financial Accounts (FBAR)
Financial (deposit and custodial) accounts held at foreign financial institutions	Yes	Yes
Financial account held at a foreign branch of a U.S. financial institution	No	Yes
Financial account held at a U.S. branch of a foreign financial institution	No	No
Foreign financial account for which you have signature authority	No, unless you otherwise have an interest in the account as described above	Yes, subject to exceptions
Foreign stock or securities held in a financial account at a foreign financial institution	The account itself is subject to reporting, but the contents of the account do not have to be separately reported	The account itself is subject to reporting, but the contents of the account do not have to be separately reported
Foreign stock or securities not held in a financial account	Yes	No
Foreign partnership interests	Yes	No

	Form 8938, Statement of Specified Foreign Financial Assets	Form TD F 90-22.1 (Now Form 104), Report of Foreign Bank and Financial Accounts (FBAR)
Indirect interests in foreign financial assets through an entity	No	Yes, if sufficient ownership or beneficial interest (i.e., a greater than 50 percent interest) in the entity. See instructions for further detail.
Foreign mutual funds	Yes	Yes
Domestic mutual fund investing in foreign stocks and securities	No	No
Foreign accounts and foreign non-account investment assets held by foreign or domestic grantor trust for which you are the grantor	Yes, as to both foreign accounts and foreign non-account investment assets	Yes, as to foreign accounts
Foreign-issued life insurance or annuity contract with a cash-value	Yes	Yes
Foreign hedge funds and foreign private equity funds	Yes	No
Foreign real estate held directly	No	No

	Form 8938, Statement of Specified Foreign Financial Assets	Form TD F 90-22.1 (Now Form 104), Report of Foreign Bank and Financial Accounts (FBAR)
Foreign real estate held through a foreign entity	No, but the foreign entity itself is a specified foreign financial asset and its maximum value includes the value of the real estate	No
Foreign currency held directly	No	No
Precious Metals held directly	No	No
Personal property, held directly, such as art, antiques, jewelry, cars and other collectibles	No	No
'Social Security'-type program benefits provided by a foreign government	No	No

Section: US Canada Convention

Canadian Pension Beneficiaries Will No Longer Need to File Form 8891 to Report Income on Deferral Basis, Retroactive Relief Granted to Individuals Who Failed to File the Form Previously

Citation: Revenue Procedure 2014-55, 10/8/14

In Revenue Procedure 2014-55 the IRS has simplified the reporting for beneficiaries of Canadian retirement plans (RRSP or RRIF). The procedure will make Form 8891 obsolete as of December 31, 2014, as well as granting retroactive relief back to taxable years beginning on or after January 1, 1996.

Previously United States residents or citizens who held interests in such plans were by default exposed to current taxation by the United States on the income of such plans, with Canadian tax imposed on the distribution when funds were withdrawn. The U.S. taxed the plans because they are not United States qualified retirement plans. However, because U.S. tax was paid years before any Canadian tax would generally be paid, there was no ability to use a foreign tax credit to obtain relief from this double taxation by the two countries.

The Convention between the United States and Canada provided an optional form of relief. A person in that awkward position could, under paragraph 7 of Article XVIII of the Convention could elect to defer United States taxation until funds were distributed from the plan.

The IRS initially established rules under Revenue Procedure 2002-23 for affected individuals to make this election. Under that procedure, a taxpayer had to attach a statement to each return on which they were claiming a deferral treatment for U.S. purposes that included:

- A statement that the taxpayer is claiming the benefit of Article XVIII(7) of the Convention;
- The name of the trustee of the plan and the plan account number; and
- The balance in the plan at the beginning of the taxable year in which the election is being made

The election had to be made on a timely filed (including extensions) federal income tax return.

As well, since the Canadian pension was a foreign trust, taxpayers with such accounts had to, by default, file the appropriate foreign trust reporting forms (Form 3520 and/or Form 3520-A). Such accounts also would generally trigger reporting related to foreign financial assets under IRC §6038D on Form 8938.

In 2004 the IRS released Form 8891, U.S. Information Return for Beneficiaries of Certain Canadian Retirement Plans to simplify making the election to defer income and to eliminate the foreign trust and account reporting related to these assets. An affected taxpayer who filed Form 8891 was deemed to make the election to defer the income under the Convention. Use of the form also eliminated the need to file Forms 3520, 3520-A or 8938 for these accounts, though the taxpayers did note on Form 8938 that they had reporting the trust items on Form 8891.

If a taxpayer failed to file a Form 8891 and make the election (as many did out of simple ignorance) they were subject to tax on the current earnings—that is, the "default" treatment mentioned above. They also ended up with exposure to significant penalties for failing to file the information returns otherwise required for foreign trusts and the FACTA reporting on Form 8938. Taxpayers who later discussed the error of their ways found their only recourse was to seek relief form the IRS by asking for a letter ruling granting a late election to defer—an expensive proposition.

However the new ruling retroactively solves the problem for most affected taxpayers. Generally taxpayers who meet the following requirements will be allowed to simply report Canadian pension income as the funds are distributed:

- Is or at any time was a U.S. citizen or resident (within the meaning of section 7701(b)(1)(A)) while a beneficiary of the plan;
- Has satisfied any requirement for filing a U.S. Federal income tax return for each taxable year during which the individual was a U.S. citizen or resident;
- Has not reported as gross income on a U.S. Federal income tax return the earnings that accrued in, but were not distributed by, the plan during any taxable year in which the individual was a U.S. citizen or resident; and
- Has reported any and all distributions received from the plan as if the individual had made an election under Article XVIII(7) of the Convention for all years during which the individual was a U.S. citizen or resident

Thus taxpayers who, in their ignorance, simply had not been reporting the accrued income from the plan but had otherwise been filing U.S. returns as due are deemed to have elected the deferred income reporting method of the Convention. The taxpayer's election is treated as retroactive to the first year that the taxpayer should have filed a formal election.

If a taxpayer had been reporting the income earned on the trust each year on his/her own return, that taxpayer will need the IRS's permission to make a deferral election.

Because the form is no longer necessary, the IRS announced that Form 8891 will be rendered obsolete on December 31, 2014. This means the form should still be attached to 2013 returns, but will not be attached to 2014 returns.

Such individuals will also not need to file 3520, nor will trustees of the plan need to file Form 3520A. However, the procedure makes clear that taxpayers with such accounts will still need to comply with the FBAR reporting obligations related to such accounts nor FACTA reporting required under IRC §6038D.

The IRS provides the following example of the application of this Revenue Procedure:

> Taxpayer is a U.S. citizen and a resident of Canada who established an RRSP in 2004 and filed Form 1040, U.S. Individual Income Tax Return, for 2004 and all subsequent taxable years. Taxpayer did not attach to any Form 1040 a Form 8891 with respect to the RRSP and did not make an election under the procedures set forth in Revenue Procedure 2002-23. Taxpayer also did not include as gross income on any Form 1040 any earnings that accrued in the RRSP during 2004 and subsequent taxable years. Taxpayer has not received any distributions from the RRSP. Pursuant to section 4.01 of this revenue procedure, Taxpayer is an eligible individual and, pursuant to section 4.02 of this revenue procedure, will be treated as having made an election under Article XVIII(7) of the Convention to defer current U.S. income taxation on the undistributed income for 2004 and all subsequent taxable years through the taxable year in which there is a final distribution from the RRSP. When Taxpayer receives distributions from the RRSP, the entire amount of each distribution will be subject to U.S. Federal income tax. In addition, Taxpayer is not required to report his interest in the RRSP on Form 8891, Form 3520, or Form 3520-A. However, Taxpayer may need to report his interest in the RRSP under section 6038D or under another provision of U.S. law, including the

requirement to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), imposed by 31 U.S.C. § 5314 and the regulations thereunder.

Section: 1
Inflation Adjusted Numbers Issued by IRS for 2014

Citation: Revenue Procedure 2013-35, 10/30/14

The IRS released inflation adjusted amounts for 2014 in Revenue Procedure 2014-61.

The tax tables for 2015 will be:

Married Couples Filing a Joint Return

If Taxable Income Is:	The Tax Is:
Not over $18,450	10% of the taxable income
Over $18,450 but not over $74,900	$1,845 plus 15% of the excess over $18,450
Over $74,900 but not over $151,200	$10,312.50 plus 25% of the excess over $74,900
Over $151,200 but not over $230,450	$29,837.50 plus 28% of the excess over $151,200
Over $230,450 but not over $411,500	$51,577.50 plus 33% of the excess over $230,450
Over $411,500 but not over $464,850	$111,324 plus 35% of the excess over $411,500
Over $464,850	$129,996.50 plus 39.6% of the excess over $464,850

Heads of Household

If Taxable Income Is:	The Tax Is:
Not over $13,150	10% of the taxable income
Over $13,150 but not over $50,200	$1,315 plus 15% of the excess over $13,150
Over $50,200 but not over $129,600	$6,872.50 plus 25% of the excess over $50,200
Over $129,600 but not over $209,850	$26,722.50 plus 28% of the excess over $129,600
Over $209,850 but not over $411,500	$49,192.50 plus 33% of the excess over $209,850
Over $411,500 not over $439,000	$115,737 plus 35% of the excess over $411,500
Over $439,000	$125,362 plus 39.6% of the excess over $439,000

Single

If Taxable Income Is:	The Tax Is:
Not over $9,225	10% of the taxable income
Over $9,225 but not over $37,450	$922.50 plus 15% of the excess over $9,225
Over $37,450 but not over $90,750	$5,156.25 plus 25% of the excess over $37,450
Over $90,750 but not over $189,300	$18,481.25 plus 28% of the excess over $90,750
Over $189,300 but not over $411,500	$46,075.25 plus 33% of the excess over $189,300
Over $411,500 not over $413,200	$119,401 plus 35% of the excess over $411,500
Over $413,200	$119,996 plus 39.6% of the excess over $413,200

Married Filing Separate Returns

If Taxable Income Is:	The Tax Is:
Not over $9,225	10% of the taxable income

Over $9,225 but not over $37,450	$922.50 plus 15% of the excess over $9,225
Over $37,450 but not over $75,600	$5,156.25 plus 25% of the excess over $37,450
Over $75,600 but not over $115,225	$14,693.75 plus 28% of the excess over $75,600
Over $115,225 but not over $205,750	$ 25,788.75 plus 33% of the excess over $115,225
Over $205,750 not over $232,425	$ 55,662 plus 35% of the excess over $205,750
Over $232,425	$ 64,989.25 plus 39.6% of the excess over $232,425

Estates and Trusts

If Taxable Income Is:	The Tax Is:
Not over $2,500	15% of the taxable income
Over $2,500 but not over $5,900	$375 plus 25% of the excess over $2,500
Over $5,900 but not over $9,050	$1,225 plus 28% of the excess over $5,900
Over $9,050 but not over $12,300	$2,107 plus 33% of the excess over $9,050
Over $12,300	$3,179.50 plus 39.6% of the excess over $12,300

Other inflation-adjusted items in the notice are:

Unearned Income Taxed As if Parent's Income ("Kiddie Tax")	Unearned income in excess of $1,050
Adoption Credit	Maximum credit for both special needs adoptions and other adoptions is $13,400. The credit begins to phase out at adjusted gross income of $201,010 and is fully phased out at $241,010
Child Tax Credit	The value used to determine the amount under §24 that may be refundable is $3,000
Hope Scholarship Credit	100% of expenses not in excess of $2,000 plus 25% of next $2,000, for a maximum credit of $2,500. Modified adjusted gross income in excess of $80,000 ($160,000 for a joint return) is used to determine the reduction in the credit
Lifetime Learning Credit	Modified adjusted gross income in excess of $55,000 ($110,000 for a joint return) is used to determine the reduction in the credit

Earned Income Credit

The threshold phase-out amounts and completed phase-out amounts for 2015 for married couples filing a joint return:

	Number of Qualifying Children			
Item	**One**	**Two**	**Three or More**	**None**
Earned Income Amount	$9,880	$13,870	$13,870	$6,580
Maximum Amount of Credit	3,359	5,548	6,242	503

Threshold Phaseout Amount (Single, Surviving Spouse or Head of Household)	18,110	18,110	18,110	8,240
Completed Phaseout Amount(Single, Surviving Spouse or Head of Household)	39,131	44,454	47,747	14,820
Threshold Phaseout Amount (Married Filing Jointly)	23,630	23,630	23,630	13,750
Completed Phaseout (Married Filing Jointly)	44,651	49,974	53,267	20,330

Excess Investment Income for Earned Income Credit	EITC not allowed if investment income exceeds $3,400
Rehabilitation Expenditures Treated as Separate New Building	The per low-income unit qualified basis amount under §42(e)(3)(A)(ii)(II) is $6,500

Refundable Credit for Coverage Under a Qualified Health Plan. For taxable years beginning in 2015, the limitation on tax imposed under § 36B(f)(2)(B) for excess advance credit payments is determined using the following table:

If the household income (expressed as a percent of poverty line) is:	The limitation amount for unmarried individuals (other than surviving spouses and heads of household) is:	The limitation amount for all other taxpayers is:
Less than 200%	$300	$600
At least 200% but less than 300%	$750	$1,500
At least 300% but less than 400%	$1,250	$2,500

Rehabilitation Expenditures Treated as Separate New Building	For calendar year 2015, the per low-income unit qualified basis amount under § 42(e)(3)(A)(ii)(II) is $6,600.
Low-Income Housing Credit	The amount used to calculate the State housing ceiling is the greater of (1) $2.30 multiplied by the State population or (2) $2,680,000

Employee Health Insurance Credit under §45R	The average wage phase-out begins at $25,800
Exemption Amounts for Alternative Minimum Tax	Joint Returns or Surviving Spouses $83,400
	Single and Head of Household $53,600
	Married Individuals Filing a Separate Return $41,700
	Estates and Trusts $23,800
AMTI Level at Which the 28% Rate Applies	Married Individuals Filing Separate Returns $92,700
	Other Taxpayers $185,400
AMT Phaseout of Exemption Amounts Begin at	Joint Returns or Surviving Spouses $158,900
	Single and Head of Household $119,200
	Married Individuals Filing Separate Returns $79,450
AMT Exemption for Child Subject to the "Kiddie Tax"	The child's earned income plus $7,400
Transportation Mainline Pipeline Construction Industry Optional Expense Substantiation Rules for Payments to Employees under Accountable Plans	Up to $17 an hour for rig related expenses if the employer does not reimburse fuel. Up to $11 an hour if the employer does reimburse fuel [Rev Proc 2002–41]
Standard Deduction	Married Individuals Filing a Joint Return and Surviving Spouses $12,600
	Heads of Household $9,250
	Single $6,300
	Married Individuals Filing Separate Returns $6,300
Standard Deduction for Person Who May be Claimed as a Dependent	Greater of $1,050 or the sum of $350 and the individual's earned income
Aged or Blind Additional Standard Deduction	The additional standard deduction is $1,250. The amount is increased to $1,550 if the individual is unmarried and not a surviving spouse
Overall Limit on Itemized Deductions ("Pease" Limitation) Begins to Apply	Joint return or Surviving Spouse $309,900
	Head of Household $284,050
	Single $258,250
	Married Individual Filing a Separate Return $154,950
Cafeteria Plan Medical FSA Deferrals	Maximum of $2,550
Qualified Transportation Fringe Benefit	Monthly limitation for transportation in a commuter highway vehicle and any transit pass is $130. Monthly maximum exclusion for qualified parking is $250
United State Savings Bonds Higher Education Expenses	Exclusion begins to phase out for modified gross income above $115,750 for joint returns and $77,200 for other returns. The exclusion completely phases out for modified adjusted gross income of $145,750 or more for joint returns and $92,200 or more for other returns
Adoption Assistance Programs	The limits and phase outs are the same as for the adoption credit

Personal Exemption	$4,000
Personal Exemption Phase-Out	Married filing joint and surviving spouse begins at $309,900 and is completely phased out at $432,400
	Heads of household begins at $284,050 and is completely phased out at $406,550
	Single begins at $258,250 and is completely phased out at $380,750
	Married individuals filing separate returns begins at $154,950 and is completely phased out at $216,200
Eligible Long-Term Care Premiums Limit Based on Age Attained at Close of Taxable Year	40 or less $380
	More than 40 but not more than 50 $710
	More than 50 but not more than 60 $1,430
	More than 60 but not more than 70 $3,800
	More than 70 $4,750
Medical Savings Account High Deductible Health Plan	Self-only coverage: annual deductible not less than $2,200 and not more than $3,300, with a maximum out of pocket of no more than $4,450
	Family coverage: annual deductible not less than $4,450 and not more than $6,650, with a maximum out of pocket of no more than $8,150
Interest on Education Loans	Begins to phase out at modified adjusted gross income of $65,000 ($130,000 for joint returns) and is completely phased out at MAGI of $80,000 or more ($160,000 or more for joint returns)
Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund Raising Campaigns	For purposes of defining the term "unrelated trade or business" for certain exempt organizations under § 513(h)(2), "low cost articles" are articles costing $10.50 or less.
	Under § 170, the $5, $25, and $50 guidelines in section 3 of Rev. Proc. 90-12, 1990-1 C.B. 471 (as amplified by Rev. Proc. 92-49, 1992-1 C.B. 987, and modified by Rev. Proc. 92-102, 1992-2 C.B. 579), for the value of insubstantial benefits that may be received by a donor in return for a contribution, without causing the contribution to fail to be fully deductible, are $10.50, $52.50, and $105, respectively.
Covered Expatriate	An individual generally is a covered expatriate if the individual's "average annual net income tax" under §877(a)(2)(A) for the five taxable years ending before the expatriation date is more than $160,000.
Tax Responsibilities for Expatriation	The amount that would be includible in the gross income of a covered expatriate by reason of § 877A(a)(1) is reduced (but not below zero) by $690,000.
Foreign Earned Income Exclusion	$100,800

Unified Credit Against Estate Tax	Basic exclusion amount for 2014 is $5,430,000
Valuation of Qualified Real Property in Decedent's Gross Estate	If the executor elects to use the special use valuation method under § 2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use § 2032A for purposes of the estate tax cannot exceed $1,100,000.
Annual Exclusion for Gifts	Present interest gifts $14,000
	Gifts to spouse who is not a citizen of the United States $147,000
Notice of Large Gifts Received from Foreign Persons	$15,601
Interest on a Certain Portion of an Estate Tax Payable in Installments	The dollar amount used to determine the "2-percent portion" (for purposes of calculating interest under § 6601(j)) of the estate tax extended as provided in § 6166 is $1,470,000.
Periodic Payments Received under Qualified Long-Term Care Insurance Contracts or under Certain Life Insurance Contracts	The stated dollar amount of the per diem limitation under § 7702B(d)(4), regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual, is $330.

Section: 2
Head of Household Filing Status Not Available to Individual Whose Spouse's Absence Solely Employment Related

Citation: Chief Counsel Email Advice 201334041, 8/23/13

Sometimes it's useful to review the basics to make sure you know what you think you know. In Chief Counsel Email Advice 201334041 (http://www.irs.gov/pub/irs-wd/1334041.pdf) we are reminded that you need to look at the details of a situation.

In the matter leading to the question, a married couple had been living apart due to an employment assignment received by one of the spouses. The spouses lived apart for the last six months of the year. The question is whether the spouse living with the child could file as head of household.

Assuming the other requirements are met, a married individual can still file head of household if, under IRC §2(b)(3) "[d]uring the last 6 months of the taxable year, such individual's spouse is not a member of such household." So you might conclude that the answer would be yes.

However, "not a member of the household" is not necessarily the same thing as not present in the home. That is one possible interpretation, but not necessarily the only one.

Dealing with ambiguities in the law is what regulations are designed to deal with. And, in this case, Reg. §1.7703-1(b)(5) provides "[a]n individual's spouse will be considered to be a member of the household during temporary absences from the household due to special circumstances. A nonpermanent failure to occupy such household as his abode by reason of illness, education, business, vacation, or military service shall be considered a mere temporary absence due to special circumstances."

In this case, the email notes that "[t]he taxpayer and the taxpayer's spouse were never legally separated and did not intend to live apart permanently." Thus, the email concludes the employment related absence was just such a "nonpermanent failure" and that the spouse was still a member of the household. Thus, the taxpayer was not eligible to file using a head of household filing status.

Section: 25D
Energy Credit Qualification Details Updated by IRS

Citation: Notice 2013-70, 11/1/13

Details on items that qualify for the credits for nonbusiness energy property under IRC §25C and residential energy efficient property under IRC §25D and additional issues on the credits are found in IRS Notice 2013-70 (http://www.irs.gov/pub/irs-drop/n-13-70.pdf).

The credit under §25C is equal to the sum of:

- 10 percent of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the year, and
- The amount of the residential energy property expenditures paid or incurred by the taxpayer during the year.

The property must be placed in service by December 31, 2013.

The credit under IRC §25D applies to expenditures made for "residential energy efficient property" for property placed in service by December 31, 2016.

The notice is presented in question and answer format outlining various factors with regard to these credits. The new notice does provide some additional details, including clarifying that certain items qualify for the credit. This clarification may mean that taxpayers who previously had made such expenditures but did not claim the credit may have a claim for refund if the statute of limitations has not yet expired on the year in question.

The credit under §25C for "nonbusiness energy property" is not available for items installed in a second residence. Similarly, the credit under §25D for fuel cell property is not available for items installed in a second residence. However, the Notice provides that other qualifying §25D property can be installed in a second residence and the credit claimed. Such other property includes:

- Solar electric property
- Solar water heating property
- Small wind energy property, and
- Geothermal heat pump property

The notice points out that the costs of the property includes, in addition to the base cost of the item in question, labor costs for onsite preparation, assembly, or original installation of the items in question. As well, the sales tax paid is considered part of the cost of the unit.

The notice attempts to "clarify" the treatment of subsidies provided for the acquisition of such items. Generally the notice rules that if the amount of the payment is a §136 subsidy from a utility not required to be included in the taxpayer's income, the cost of the item acquired must be reduced by that subsidy. However, the notice then goes on to note that "[n]ot all payments from a public utility fall within the provisions of §136."

Thus, it would appear that prior private guidance from the IRS on certain programs (such as the Arizona utility's solar energy program described in PLR 201035003, http://www.irs.gov/pub/irs-wd/1035003.pdf) would still apply. In that ruling, a particular program conducted by an Arizona utility was found to not be a subsidy under IRC §136. Thus the payments were included in a taxpayer's income, but the cost of the property was not reduced when computing the credit.

The notice also points that actual rebates form a properly related party to the transaction (manufacturer, distributor, or seller/installer) and which are not payments or compensation for services reduce the cost for purposes of the credit. However, state energy efficiency incentives do not reduce the basis of the property, even though many states call such payments "rebates." Similarly, the cost is not reduced by any state tax credits given for such property.

Interest paid on financing the property and other costs (extended warranties, origination fees, etc.) are not included as part of the cost of the property eligible for the credit. The credit is also not available if the taxpayer leases rather than purchases the property.

The notice clarifies that a window sash replacement kit is considered an exterior window for purposes of the §25C credit even though the item does not represent the entire window.

For purposes of the §25D credit, if the taxpayer buys a newly constructed home, the taxpayer may request the homebuilder make a reasonable allocation to qualifying property or use another reasonable method to estimate the cost of such property. Such property qualifies for the credit in the year in which the taxpayer begins to use the property even if construction was completed in the prior year. As well, use of the items as part of a model home does not disqualify the buyer of the model home from being able to claim the credit.

The notice deal with special provisions for solar energy items. The notice points out that the solar panels do not have to be installed on the residence in question so long as they generate power for the residence. As well, the panels may be installed off-site in a solar-array so long as the panels are connected to the utility that supplies the taxpayer's residence and the amount of energy would not normally exceed the amount to be used by the taxpayer's residence.

However, if panels (even if installed on the taxpayer's residence) generate more electricity than is needed by the taxpayer's home and the taxpayer sells the excess to the utility, the credit is limited to that portion of the expenditure that is reasonably needed to generate electricity for the taxpayer's home.

A solar powered air heater is not eligible for the credit, since it is not of a type of property provided. Similarly, a solar powered exhaust fan is only eligible to the extent of the cost of the solar panel generating electricity for the exhaust fan.

Small wind energy property made from remanufactured wind turbines qualify for the §25D credit, as this credit does not require that original use begin with the taxpayer.

The ruling provides that only the heat-exchange unit in the ground beside a home will be eligible for the §25D credit for geothermal property when the taxpayer installs a geothermal heat pump. Thus the distribution system for the home and the back-up emergency heating or cooling system will be eligible for the credit.

The manufacturer of the geothermal heat pump does not need to become a member of the Energy Star program for the property to qualify, but the property must still meet the standards required for the property to have been part of the Energy Star program.

Section: 36
Eleventh Circuit Overrules Tax Court, Finds Newly Married Couple of One First-Time Homebuyer and One Long-Time Homeowner Do Not Qualify for Long-Time Homeowner Credit

Citation: Packard v. Commissioner, 139 TC No. 15, 11/5/12, reversed CA11, 113 AFTR 2d ¶ 2014-678, 3/27/14

In IRS Information Letter 2010-0117 (http://www.irs.gov/pub/irs-wd/10-0117.pdf) issued in June of 2010 the IRS determined if one member of a newly married couple never owned a residence during the three years prior to the purchase of a new residence (thus being a "first time homebuyer") while the other member had owned and occupied the same residence for three of the prior five years (thus being a "long-time home owner"), no credit was available under IRC §36. The IRS consistently gave this advice when asked about the issue.

However, in *Packard v. Commissioner*, 139 TC No. 15, (http://www.ustaxcourt.gov/InOpHistoric/packarddiv.TC.WPD.pdf) the Tax Court disagreed with the IRS's finding. The Court found that such a result was clearly absurd, as either spouse would have qualified for some sort of "first time" homebuyer credit under IRC §36 as it was in place at the time. The Court noted Congress enacted the long-time homebuyer provision to expand qualification for the credit and disagreed with the IRS that the plain language of the statute required that both spouses had to meet the same criteria.

Thus, the Court found the couple qualified to receive the reduced "long-time" homebuyer's credit of $6,500 despite the fact that Mr. Packard was a first-time homebuyer, rather than long-time homeowner.

While the credit is not currently still in force, there nevertheless will be taxpayers who married during the time period when this provision was in force who will need to move to file claims for refund before the statute expires on claiming a refund, a date that will be rapidly approaching for many of these clients.

However, on February 5, 2013 the IRS announced they had filed an appeal of this decision to the Eleventh Circuit Court of Appeals in this matter and, on appeal, the Eleventh Circuit agreed with the IRS position, overturning the Tax Court decision (113 AFTR 2d ¶ 2014-678, http://www.ca11.uscourts.gov/opinions/ops/201310586.pdf). The Court of Appeals found that the plain language of the statute required, as the IRS asserted, that both spouses had to meet the same test.

The appellate panel goes on to note:

> Further, the Commissioner's reading of § 36(c) did not produce an absurd result, as the Tax Court suggested without explaining. The absurdity exception to the plain-meaning rule only comes into play where the absurdity is "so gross as to shock the general moral or common sense." ... Here, the plain language in § 36(c)(1) and § 36(c)(6) of the Internal Revenue Code makes clear Congress's intent to treat married couples as a single inseparable unit for purposes of determining first-time homebuyer eligibility. While the effect of enforcing the statute as written may seem inequitable in light of the facts of this case, it does not shock general moral or common sense. Deductions and credits are matters of legislative grace and are not allowable unless Congress specifically provides for them.

The case was remanded to the Tax Court.

The situation does produce an interesting issue that advisers should be aware of. The original opinion issued by the Tax Court was a published opinion and, unless the Tax Court specifically indicates that, upon reconsideration, it no longer holds to that position, is technically still the position of the Court outside of the

Eleventh Circuit. In the Eleventh Circuit the Tax Court, under the *Golsen* rule, will require both spouses to meet the criteria.

But that same rule holds that outside the Eleventh Circuit the Tax Court will continue to apply what it officially holds is the "proper" result. Of course, given the IRS victory on appeal, taxpayers who are seeking refunds may find the IRS inclined to require the taxpayers to litigate the matter into their Circuit Court of Appeals—not an economically viable prospect generally given the maximum dollar amounts involved in the credit.

Section: 36B
Affordable Percentages for 2016 Released by IRS

Citation: Revenue Procedure 2014-62, 11/21/14

The inflation-adjusted percentage of household income that applies for the §36B credit for 2016 was announced by the IRS in Revenue Procedure 2014-62.

For year 2016 the rate tables are as follows:

Household income percentage of Federal poverty line:	Initial percentage	Final percentage
Less than 133%	2.03%	2.03%
At least 133% but less than 150%	3.05%	4.07%
At least 150% but less than 200%	4.07%	6.41%
At least 200% but less than 250%	6.41%	8.18%
At least 250% but less than 300%	8.18%	9.66%
At least 300% but not more than 400%	9.66%	9.66%

The ruling also provide the number that will be used in 2016 to determine if an individual is eligible for affordable employer sponsored coverage. That percentage for 2016 will be 9.66%

Section: 36B
IRS Provides Special Rule for Pregnant Women Temporarily Eligible for Medicaid or CHIP Coverage, May Continue to Qualify for Premium Credit if Continue to Pay Premiums

Citation: Notice 2014-71, 11/7/14

The IRS issued a special rule to deal with potential complications under the health care premium credit under §36B for individuals who become eligible for short term pregnancy related coverage under Medicaid and the Children's Health Insurance Program.

In Notice 2014-71 the IRS provided that:

> An individual enrolled in a qualified health plan who becomes eligible for Medicaid coverage for pregnancy-related services that is minimum essential coverage, or for CHIP coverage based on pregnancy, is treated as eligible for minimum essential coverage under the Medicaid or CHIP coverage for purposes of the premium tax credit only if the individual enrolls in the coverage.

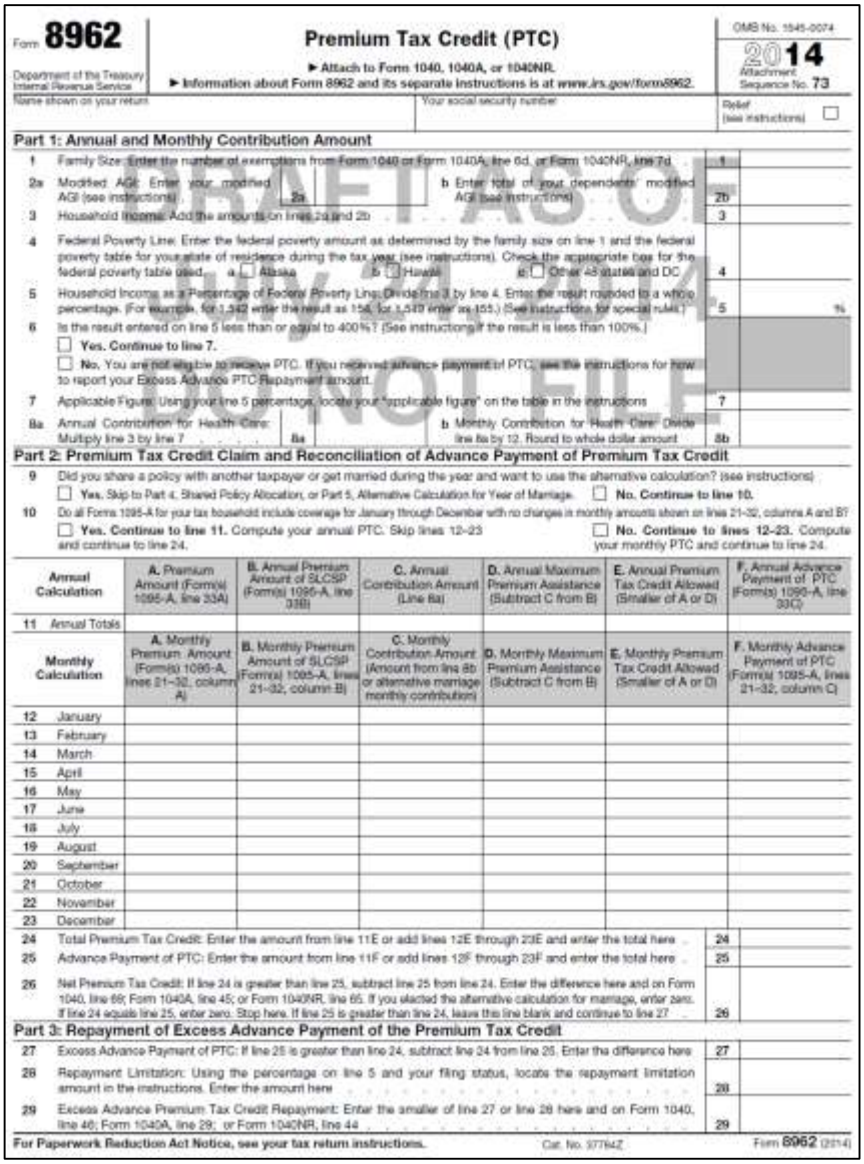
Coverage under the program only applies for a limited period of time—the duration of the pregnancy plus 90 days. Without the above rule, a woman who kept her commercial health insurance during her pregnancy (rather than going off the plan and then having to rejoin 90 days after giving birth) would have lost the ability to obtain the credit to subsidize the purchase of coverage.

Section: 36B
IRS Releases Reconciliation of Premium Tax Credit Form

Citation: Draft Form 8962, 7/24/14

The IRS has issued a draft of the form to be used by taxpayers to reconcile their premium tax credit under IRC §36B with the amount of benefit they received during the year. Taxpayers may end receiving an additional credit or be required to pay back some of all of their assistance based on their actual 2014 income.

The draft from is found at http://www.irs.gov/pub/irs-dft/f8962--dft.pdf.



Form **8962** — Department of the Treasury, Internal Revenue Service

Premium Tax Credit (PTC)

► Attach to Form 1040, 1040A, or 1040NR.
► Information about Form 8962 and its separate instructions is at www.irs.gov/form8962.

OMB No. 1545-0074 — 2014 — Attachment Sequence No. 73

Name shown on your return | Your social security number | Relief (see instructions) ☐

DRAFT AS OF July 24, 2014 DO NOT FILE

Part 1: Annual and Monthly Contribution Amount

1 Family Size: Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d — 1

2a Modified AGI: Enter your modified AGI (see instructions) — 2a; b Enter total of your dependents' modified AGI (see instructions) — 2b

3 Household Income: Add the amounts on lines 2a and 2b — 3

4 Federal Poverty Line: Enter the federal poverty amount as determined by the family size on line 1 and the federal poverty table for your state of residence during the tax year (see instructions). Check the appropriate box for the federal poverty table used. a ☐ Alaska b ☐ Hawaii c ☐ Other 48 states and DC — 4

5 Household Income as a Percentage of Federal Poverty Line: Divide line 3 by line 4. Enter the result rounded to a whole percentage. (For example, for 1.542 enter the result as 154, for 1.549 enter as 155.) (See instructions for special rules.) — 5 %

6 Is the result entered on line 5 less than or equal to 400%? (See instructions if the result is less than 100%.)
☐ **Yes. Continue to line 7.**
☐ **No.** You are not eligible to receive PTC. If you received advance payment of PTC, see the instructions for how to report your Excess Advance PTC Repayment amount.

7 Applicable Figure: Using your line 5 percentage, locate your "applicable figure" on the table in the instructions — 7

8a Annual Contribution for Health Care: Multiply line 3 by line 7 — 8a; b Monthly Contribution for Health Care: Divide line 8a by 12. Round to whole dollar amount — 8b

Part 2: Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Did you share a policy with another taxpayer or get married during the year and want to use the alternative calculation? (see instructions)
☐ **Yes.** Skip to Part 4, Shared Policy Allocation, or Part 5, Alternative Calculation for Year of Marriage. ☐ **No. Continue to line 10.**

10 Do all Forms 1095-A for your tax household include coverage for January through December with no changes in monthly amounts shown on lines 21–32, columns A and B?
☐ **Yes. Continue to line 11.** Compute your annual PTC. Skip lines 12–23 and continue to line 24. ☐ **No. Continue to lines 12-23.** Compute your monthly PTC and continue to line 24.

Annual Calculation	A. Premium Amount (Form(s) 1095-A, line 33A)	B. Annual Premium Amount of SLCSP (Form(s) 1095-A, line 33B)	C. Annual Contribution Amount (Line 8a)	D. Annual Maximum Premium Assistance (Subtract C from B)	E. Annual Premium Tax Credit Allowed (Smaller of A or D)	F. Annual Advance Payment of PTC (Form(s) 1095-A, line 33C)
11 Annual Totals						
Monthly Calculation	**A.** Monthly Premium Amount (Form(s) 1095-A, lines 21–32, column A)	**B.** Monthly Premium Amount of SLCSP (Form(s) 1095-A, lines 21–32, column B)	**C.** Monthly Contribution Amount (Amount from line 8b or alternative marriage monthly contribution)	**D.** Monthly Maximum Premium Assistance (Subtract C from B)	**E.** Monthly Premium Tax Credit Allowed (Smaller of A or D)	**F.** Monthly Advance Payment of PTC (Form(s) 1095-A, lines 21–32, column C)
12 January						
13 February						
14 March						
15 April						
16 May						
17 June						
18 July						
19 August						
20 September						
21 October						
22 November						
23 December						

24 Total Premium Tax Credit: Enter the amount from line 11E or add lines 12E through 23E and enter the total here — 24

25 Advance Payment of PTC: Enter the amount from line 11F or add lines 12F through 23F and enter the total here — 25

26 Net Premium Tax Credit: If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27 — 26

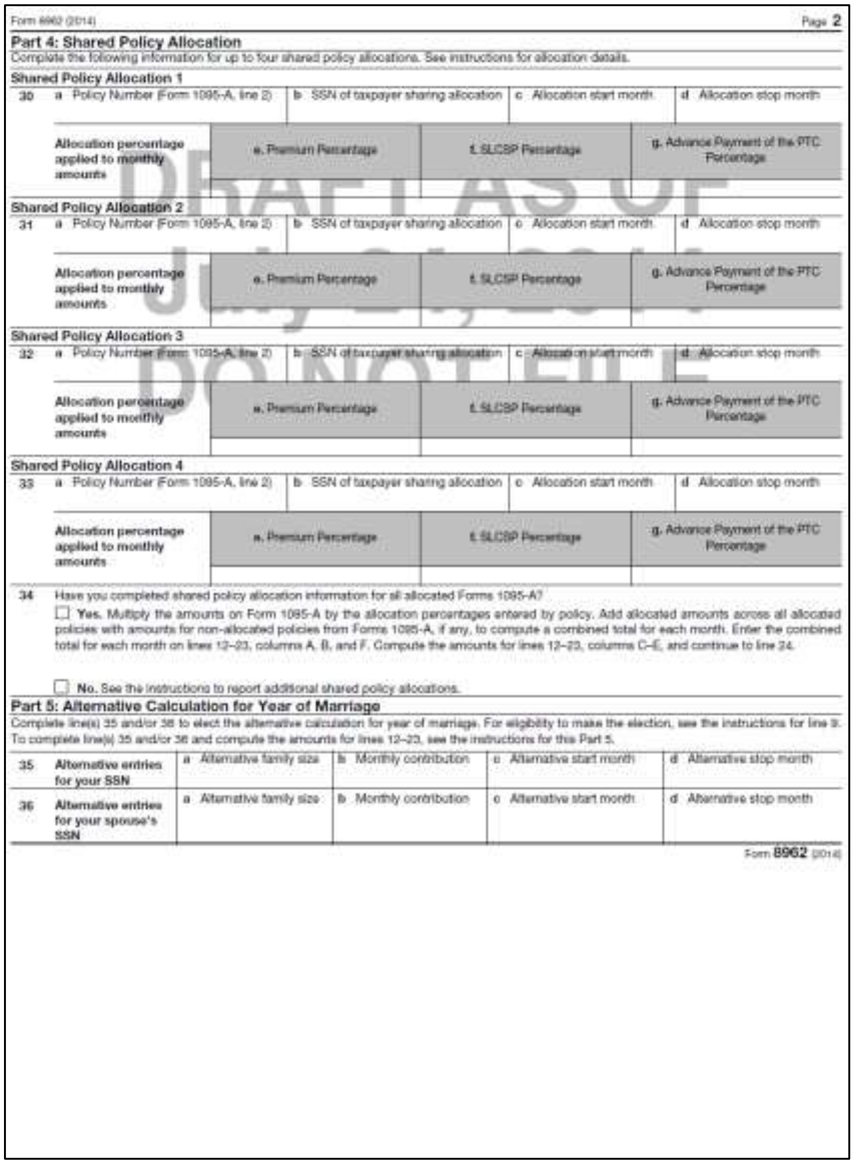
Part 3: Repayment of Excess Advance Payment of the Premium Tax Credit

27 Excess Advance Payment of PTC: If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here — 27

28 Repayment Limitation: Using the percentage on line 5 and your filing status, locate the repayment limitation amount in the instructions. Enter the amount here — 28

29 Excess Advance Premium Tax Credit Repayment: Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44 — 29

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37784Z Form **8962** (2014)


Form 8962 (2014) Page 2

Part 4: Shared Policy Allocation

Complete the following information for up to four shared policy allocations. See instructions for allocation details.

Shared Policy Allocation 1

30	a Policy Number (Form 1095-A, line 2)	b SSN of taxpayer sharing allocation	c Allocation start month	d Allocation stop month
Allocation percentage applied to monthly amounts	e. Premium Percentage	f. SLCSP Percentage	g. Advance Payment of the PTC Percentage	

Shared Policy Allocation 2

31	a Policy Number (Form 1095-A, line 2)	b SSN of taxpayer sharing allocation	c Allocation start month	d Allocation stop month
Allocation percentage applied to monthly amounts	e. Premium Percentage	f. SLCSP Percentage	g. Advance Payment of the PTC Percentage	

Shared Policy Allocation 3

32	a Policy Number (Form 1095-A, line 2)	b SSN of taxpayer sharing allocation	c Allocation start month	d Allocation stop month
Allocation percentage applied to monthly amounts	e. Premium Percentage	f. SLCSP Percentage	g. Advance Payment of the PTC Percentage	

Shared Policy Allocation 4

33	a Policy Number (Form 1095-A, line 2)	b SSN of taxpayer sharing allocation	c Allocation start month	d Allocation stop month
Allocation percentage applied to monthly amounts	e. Premium Percentage	f. SLCSP Percentage	g. Advance Payment of the PTC Percentage	

34 Have you completed shared policy allocation information for all allocated Forms 1095-A?

☐ **Yes.** Multiply the amounts on Form 1095-A by the allocation percentages entered by policy. Add allocated amounts across all allocated policies with amounts for non-allocated policies from Forms 1095-A, if any, to compute a combined total for each month. Enter the combined total for each month on lines 12–23, columns A, B, and F. Compute the amounts for lines 12–23, columns C–E, and continue to line 24.

☐ **No.** See the instructions to report additional shared policy allocations.

Part 5: Alternative Calculation for Year of Marriage

Complete line(s) 35 and/or 36 to elect the alternative calculation for year of marriage. For eligibility to make the election, see the instructions for line 9. To complete line(s) 35 and/or 36 and compute the amounts for lines 12–23, see the instructions for this Part 5.

35	Alternative entries for your SSN	a Alternative family size	b Monthly contribution	c Alternative start month	d Alternative stop month
36	Alternative entries for your spouse's SSN	a Alternative family size	b Monthly contribution	c Alternative start month	d Alternative stop month

Form **8962** (2014)

DRAFT AS OF July 21, 2014 DO NOT FILE

Section: 36B
DC Circuit and Fourth Circuit Disagree on Whether Insurance Premium Credit Available to Individuals in States Without State Sponsored Exchange

Citation: Halbig, et al. v. Burwell, CA DC, 114 AFTR 2d ¶ 2014-5068, King v. Burwell, 114 AFTR 2d ¶ 2014 5071 , 7/22/14

While obtaining conflicting results in different Circuit Courts of Appeal on matters occurs from time to time, it's not often the conflicting decisions are issued on the same day. But this is what occurred with regard to the validity of IRS regulations for the premium tax credit under IRC §36B.

The Court of Appeals for District of Columbia found that the regulations were invalid in the case of *Halbig, et al. v. Burwell*, CA DC, 114 AFTR 2d ¶ 2014-5068 (http://www.cadc.uscourts.gov/internet/opinions.nsf/10125254d91f8bac85257d1d004e6176/$file/14-5018-1503850.pdf). However, the Fourth Circuit concluded that the regulations were valid in the case of *King v. Burwell*, 114 AFTR 2d ¶ 2014-5071 (http://scholar.google.com/scholar_case?case=15095772979412361067&hl=en&as_sdt=6&as_vis=1&oi=scholarr).

The issue is whether the premium tax credit, first available in 2014, is available to individuals in every state if the policy is purchased from a state-exchange, or whether the credit is limited only to individuals who are purchasing insurance from an exchange in the minority of states that established a state-sponsored exchange. In other states the federal government has established the exchange.

The issue revolves around IRC §36B(b)(2)(A) which provides the credit is available "which were enrolled in through an Exchange established by the *State* under 1311 of the Patient Protection and Affordable Care Act…"

However, Reg §1.36B-1(k) provides, via cross-reference, that the provisions is meant to include both purely state sponsored exchanges and those established for a state by the federal government.

The DC Circuit argues this provision is at odds with the plain language of the statute. The statute specifically refers to an exchange established by the state and the IRS regulation cannot change the unambiguous wording of the statute. That is, if Congress wanted to include the federally sponsored exchanges it should have said so in the statute.

In a move that suggests the panel was aware a contrary ruling from another Circuit was anticipated, the Court nevertheless goes on to examine the legislative history and found that there was no evidence that Congress intended to give this credit to federal exchanges.

That anticipation proved correct, as the Fourth Circuit, looking at the totality of the statute's language, the context of other relevant portions of the statute and legislative history that it was unclear if Congress did or did not mean for the credit to be available to individuals in federally sponsored exchanges. The Court placed emphasis on the stated policy goals of the Affordable Care Act and noted that the issue would have a major impact on the number of impacted Americans.

Thus, ambiguity was found to exist which, under *Chevron* standard as interpreted by the Supreme Court in the *Mayo Medical Foundation* case, opens the door for the IRS to resolve the ambiguity. And, of course, the IRS resolved that ambiguity by issuing regulations that provided the credit to individuals on both federal and state established exchanges.

The issue has importance beyond merely those who will receive (or not receive) a credit. The penalty for individuals applies only to individuals who fail to purchase affordable insurance (defined as 8% of household income). The credit lowers the cost of such insurance—so for certain individuals, not having access to the credit means that they did not have access to (by the terms of the law) *affordable* insurance and thus are not subject to the penalty.

Similarly, the employer pay or play penalty is only triggered if individuals obtain insurance from an exchange and qualify for support under the law via the §36B tax credit. Thus, it would appear, if there is no state sponsored exchange from which an individual could obtain coverage, there could not be a credit event that would trigger the penalty for the employer.

Note that none of this affects the issue in either case for the states which did establish their own exchanges—but it's a big issue elsewhere.

Presumably this split will force the Supreme Court to take up the cases and issue its own decision on the issue. But until then we are going to live with uncertainly about a number of issues related to the Affordable Care Act's mandates, both at the individual and large employer level.

Section: 61
IRS "Clarifies" Limits of California Short Sale Law's Impact on Treatment of Debt as Nonrecourse, Backing Off Earlier Letter

Citation: IRS Information Letters 2013-0036 and 2014-0024, 9/20/14

The IRS has created a bit of confusion regarding the impact of a California statute on mortgage debt—specifically whether the debt is recourse or non-recourse. The IRS letters technically are limited to interpreting the interaction of a single California statue with federal law regarding cancellation of debt may have much wider implications. But we are now on the third iteration of letters from the IRS on this issue—with the final one suggesting that some "official" guidance may be issued to (I suspect hopefully in the mind of the author of these letters) put the matter to rest.

The office of Senator Barbara Boxer of California on November 15, 2013 released a copy of an information letter from the IRS that claimed to outline the IRS position on a special provision of California's special "short sale" anti-deficiency statute (California Code of Civil Procedure 580e). The IRS released the letter as Information Letter 2013-0036 (http://www.irs.gov/pub/irs-wd/13-0036.pdf). However, as will be discussed, the IRS months later "clarified" this position—and then clarified the clarification.

The Wall Street Journal's Real Estate Developments Blog reported the release of the original letter (http://blogs.wsj.com/developments/2013/11/15/why-california-homeowners-could-avoid-tax-forgiveness-hit/).

Under CCP §580e, a lender who holds a deed of trust on a homeowner's principal residence is prohibited from seeking a deficiency judgment following a short sale. Generally a California homeowner has full anti-deficiency protection upon foreclosure if (and only if) the loan was the original debt used to acquire the property (CCP §580b protects "purchase money" debt). Any other debt has a limited anti-deficiency protection if covered by a deed of trust. Should the lender seek foreclosure under the nonjudicial provisions of the sale under the deed of trust, then the lender cannot seek a deficiency judgment. However, if the loan is not purchase money, the lender can seek a judicial foreclosure and pursue the homeowner for the shortfall. (CCP §580d)

The original letter indicates:

> We believe that a homeowner's obligation under the anti-deficiency provision of section 580e of the CCP would be a non recourse obligation to the extent that, for federal income tax purposes, the homeowner will not have cancellation of indebtedness income. Instead, the homeowner must include the full amount of the non recourse indebtedness in amount realized.

This appeared to represent a change of position for the IRS for debts that only have §580d protection (that is, that are not purchase money debt).

In the regulations under IRC §6050P that indicate events when a lender must issue a Form 1099C (for potential cancellation of debt), one of the specific events found at Reg. §1.6050P-1(b)(2) listed as a discharge trigger is:

> A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;

With a §580d "non-judicial protection only" debt, the lender by agreeing to the short sale in lieu of pursuing their rights under a judicial foreclosure would appear to be electing a foreclosure remedy that "statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness"—what the regulation considers a cancellation event.

In the case of *2925 Briarpark, Ltd. v. Commissioner*, TC Memo 1997-298, the Tax Court held that conversion of a debt from recourse to nonrecourse was not a cancellation event in the case before it—but it did so based on the fact that the lender had no reason to believe it would not receive full payment when it agreed to convert the debt to nonrecourse. Clearly a lender agreeing to a short sale has reason to believe (in fact, effective certainty) that it will not be fully repaid.

Both the regulations under §6050P and the *Briarpark* case would seem to indicate that the lender agreeing to the short sale would have triggered cancellation of debt income on the shortfall so long as the lender possessed the rights to pursue a foreclosure option that would have given it access to a deficiency. But this letter suggests that is not the result the IRS now believes is appropriate.

If the IRS believed that a §580d debt is treated under the standard nonrecourse rules in a short sale, that raises the next question—what if the lender undertakes a foreclose but pursues the non-judicial option under which the lender has waived its rights to pursue a deficiency? There seems little reason why this situation should produce a radically different result than the short sale under California's unique statute.

A number of states have rules that provide a lender gives up its right to pursue a deficiency judgment under certain conditions. For instance, Arizona, Washington and Oregon all have statutes very similar to California CCP §580d where a lender pursuing a nonjudicial foreclosure on the residence gives up the right to pursue a deficiency. It would seem the result should be the same as a California nonjudicial foreclosure—so if California §580d sales were treated as having no cancellation of indebtedness with the entire balance of the loan being sales proceeds, the same result should be obtained in those states.

Other states have different triggers—for instance in Iowa a lender may file for a type of foreclosure in which the borrower loses his/her right of redemption and the lender gives up the right to pursue collection of a deficiency (Iowa Code section 654.20). But in that case a borrower can file a demand to delay the sale in which case the lender regains the right to pursue a deficiency. Now it gets even more interesting determining the nature of the debt since the question becomes whether the borrower's right to resurrect the deficiency makes these cases "different" from the cases above.

Attempting to make sense of this letter became even more complex with the issuance of additional guidance on the matter by the California Franchise Tax Board, found at https://www.ftb.ca.gov/aboutFTB/newsroom/Mortgage_Debt_Relief_Law.shtml. That posting clarified that the FTB would follow the IRS on the view of this statute, but also very clearly noted that:

> The IRS guidance is limited to short sales only involving a principal residence for tax years 2011 and forward. The IRS guidance did not specifically address other types of real estate transactions such as non-judicial foreclosures.

The FTB guidance suggests that the state agency grasped immediately the potential implications of this view, as well as indicating that the agency may have had doubts about the propriety of the ruling.

It turns out the IRS may also have figured out that this was a bigger deal than they thought. On April 24, 2014 the IRS issued a "clarification" to Senator Boxer. The Senator's office posted that letter (http://www.boxer.senate.gov/en/press/related/IRS_Clarification_Response_to_NonRecourse_Short_Sale_Letter.pdf).

The new IRS letter "clarifies" that the original letter applies only to debts that qualify as purchase-money debts, and does not apply to all California residential debts. This view is in line with the prior guidance issued by the IRS that indicated that a lender who had a choice of options, one that allowed for deficiency judgment and one that did not, triggered cancellation of debt income to the borrower when the lender selected the option that did not allow a deficiency judgment.

Thus, borrowers in California who entered into a short sale that left unpaid a balance on a debt that was not purchase money would have cancellation of debt income when the lender agreed to the short sale and therefore, pursuant to CCP §580e, waived its right to pursue a deficiency judgment.

Senator Boxer's office, seemingly somewhat perturbed by this apparent course reversal by the IRS, sent a new letter to the IRS asking about the impact of this "clarification" on taxpayers who may have closed a short sale in reliance on this letter. See http://www.boxer.senate.gov/en/press/related/IRS_NonRecourse_Short_Sale_Letter_Followup.pdf. So this put the ball back in the IRS's court.

On June 20, 2014 the IRS sent back its response to the Senator's office in INFO 2014-0024. The IRS released is published version of the letter on September 26, 2014 and attempts to answer the office's inquiries.

First the letter addresses the question of whether "purchase money" debt is the same as California "acquisition debt." It's pretty clear it's not, and I suspect the Senator's office realized the same, so they decided to try and pin the IRS down on this one to make clear the second is a change in position.

At this point it appears the IRS realizes that punting is an option—so the letter does just that. After giving a general discussion of the two concepts the letter states:

> Whether the term "purchase--money loan" as used in section 580b(a) of the CCP has the same meaning as acquisition indebtedness for federal income tax purposes is a question of state law, not federal income tax law. Therefore, we do not express an opinion on this matter.

The above paragraph comes immediately after two paragraphs that give the definitions found for each term under the applicable law—definitions that clearly aren't the same. While it is clearly *possible* for a debt to satisfy both definitions, it's also clearly possible to have federal "acquisition debt" that is not California "purchase money" debt.

> *Example*: Mary owns a home in California. Ten years after acquiring the home she obtains a home equity credit line and uses those funds to substantially improve the existing residence. Such a debt will not be purchase money debt for California purposes (it wasn't used to acquire the residence) but it would be acquisition debt for federal tax purposes.

Next the letter asks if a reduction in the principal balance of a homeowner's California purchase money debt would result in cancellation of indebtedness income. This time the letter doesn't avoid the question, pointing out that pursuant to Revenue Ruling 91-31 a taxpayer does have cancellation of indebtedness income when a loan modification results in a reduction of outstanding principal when the taxpayer retains the property. That is true regardless of whether the loan is recourse or nonrecourse.

Finally the Senator's office posed what was, to a Senator's office charged with constituent service, the "big" question—what happens to taxpayers who acted in reliance on the assurance found in the first letter that anyone who surrendered property in a short sale in California would not have cancellation of indebtedness income, but rather have the entire balance of the loan treated as sales proceeds. Since most often that would have resulted in a smaller nondeductible loss on sale and no cancellation income, as opposed to a larger (still nondeductible) tax loss on sale along with cancellation of indebtedness income (taxable unless an exclusion applied), taxpayers may have decided to go forward with a short sale believing it would not cost them any tax—which is not the result they may now find actually applies to their sale.

The letter gives the standard line that "you can't rely on information letters" (including the current one) but then goes on to note:

> However, your letters have identified issues regarding the interaction of state anti--deficiency statutes and federal tax law that we think warrant published guidance. Accordingly, we are considering publishing formal guidance addressing the tax consequences of a sale of real property secured by a loan that is subject to a state's anti--deficiency statute. Taxpayers will be able to rely on this guidance when they file their federal income tax returns.

Of course that leaves open the question of what that guidance might be, and whether the IRS might decide to write a "special rule" due to the confusion (arguably of their own making) that could allow sales before a certain date to be treated as if they were related to nonrecourse debt. In any event, advisers who have clients potentially impacted by such rules (which could include any adviser with clients in states with some sort of anti-deficiency statute) may want to keep a close watch on developments in the near future.

Section: 61
Guarantor Who Fails to Pay on Debt Guarantee Does Not Recognize Cancellation of Indebtedness Income

Citation: Mylander v. Commissioner, TC Memo 2014-191, 9/17/14

Cases related to cancellation of indebtedness arising from the financial crisis in the last half of the prior decade continue to make their way in the Courts. The case of *Mylander v. Commissioner*, TC Memo 2014-191 involved the issue of a taxpayer who guarantees a debt and then fails to pay when that guarantee is called.

Cancellation of debt is specifically noted as income in IRC §61(a)(12). However, in the case of *Landreth v. Commissioner*, 50 TC 803 (1968) the Tax Court found that a guarantor generally did not recognize cancellation of indebtedness income upon failing to make good on a guarantee. The Court reasoned that the borrower, rather than the taxpayer, received the nontaxable increase in assets upon the issuance of the loan, and therefore only the borrower had income when the debt went unpaid.

The guarantees in this case are a bit involved, but the taxpayers ended up "on the hook" for a payment that they had guaranteed in exchange for the party whose debt they guaranteed agreeing to pay off a debt the taxpayers owed to another party. However, it turned out that this person failed to actually pay off that pre-existing debt of the Mylanders who ended up paying off that $400,000 debt.

This person also failed to pay on the debt the Mylanders guaranteed, and they defaulted on a portion of their guarantee.

The IRS argued in this case, though, that the situation was different than that in *Landreth*. The IRS argued that the guaranty in *Landreth* was a contingent liability but that in this case there was no contingent debt.

The IRS pointed to language in the guarantee that stated the following:

> "The liability of the undersigned Guarantor is absolute and unconditional, and is not conditional or contingent upon any other party signing this continuing Guaranty."

The court did not agree this changed the situation at all, noting that they only become liable if the original borrower failed to pay the debt—thus, despite the existence of the magic word "unconditional" in the guarantee, that did not change the fact that they only owed on this agreement if the borrower failed to pay.

The Court also found it irrelevant that upon default the liability may have converted to make the Mylanders primarily liable. As the Court noted:

> We do not see any material difference between the situation in *Landreth* and one in which a guarantor's contingent liability has ripened into a primary liability. Unlike a debtor who borrows funds, a guarantor who assumes a contingent liability does not receive an untaxed accretion of assets which is accompanied by an offsetting obligation to pay. This remains the case even after the guarantor becomes a primary obligor because of the debtor's default. Regardless of whether the guarantor is a secondary obligor or has become a primary obligor, when the debt is discharged the guarantor's net worth is not "increased over what it would have been if the original transaction had never occurred." *Landreth v. Commissioner*, 50 T.C. at 813.

The IRS argued that the taxpayers received valuable consideration for their guarantee. But the Court noted this consideration was illusory in this case, noting:

> Petitioners entered into the guaranty with Mr. Murray in exchange for the Ledbetters' promise to satisfy the Koch debt and to indemnify petitioners for any loss petitioners might incur with respect to the guaranty. The Ledbetters, however, did not keep either promise. While they did transfer the Nevada store to Mr. Koch, it was "leveraged to the hilt" and had no value. As a result, petitioners' obligation to Mr. Koch was not reduced at all by the transfer of the store, and petitioners were required to, and did, pay the Koch debt in full. Then, when the Ledbetters defaulted and petitioners began making payments on the Murray debt, the Ledbetters sent checks to petitioners that were returned for insufficient funds. The Ledbetters made no good-faith attempts to make good on their indemnity. Therefore, we find that petitioners did not receive any valuable consideration in exchange for the guaranty.

Finding no accession to wealth, the Court found no taxable income under IRC §61(a)(13).

Section: 61
Damage Award Received From Tax Adviser Related to Tax Shelter Advice Not Includible In Gross Income As Taxpayer Abandoned Alternative Plan That Would Have Reduced Tax

Citation: Cosentino v. Commissioner, TC Memo 2014-186, 9/11/14

The issue of the taxable status of awards received by a taxpayer from his tax adviser was addressed in the case of *Cosentino v. Commissioner*, TC Memo 2014-186.

A key issue when a taxpayer receives a damage award is whether the amounts received will be taxable income to the taxpayer or not. Generally when a taxpayer receives questionable tax advice, the taxpayer will file a claim against the adviser and argue for damages for taxes, interest and penalties. The argument for the tax payment generally is based on the claim that if the taxpayer had known the action the adviser was suggesting would not have led to the claimed tax savings, the taxpayer would have taken other actions to reduce his taxes.

That was exactly the claim in this case. The taxpayer had entered into a variant of a basis inflation shelter to offset a gain the taxpayer would be incurring from the sale of real estate. When the taxpayer discovered that the IRS had listed this type of arrangement as a potentially abusive one, the taxpayer filed immediate amended tax returns and paid the tax due.

The taxpayer asked for damages from the adviser who suggested the basis inflation shelter arguing that if the taxpayer had not entered into a basis inflation shelter the taxpayer would have entered into a §1031 exchange.

In CCA 201307005 the IRS had considered a similar "I would have done something differently" claim related to receipt of a damage award from a tax adviser and decided the taxpayer would not be able to exclude the amount from income. The IRS distinguished that situation from the holding in the case of *Clark v. Commissioner*, 40 BTA 333 (1939), *acq.*

In that case the taxpayer received damages when the adviser gave bad advice causing the taxpayer to file a joint return. Later the error was uncovered and it was found that had the taxpayers filed separate returns there would have been significantly less tax paid. Since the taxpayer's election to file a joint return could not corrected after the fact, the adviser paid an amount equal to the excess tax. In that case, the Court found that the payment was clearly for taxes that never needed to be paid, thus simply restoring the taxpayer to the state they should have been in—thus, the award was not taxable.

However, in the case in the CCA the IRS pointed out that there was no evidence the taxpayer had abandoned an alternative that would have had the same effect nor any evidence any such arrangement was under consideration. While it was clear in *Clark* that the taxpayer had relied on the adviser for a simple binary choice (file joint or separate), there was no such binary issue here.

Not surprisingly, the IRS argued the same thing in this case.

But this case had a few unique facts. While the case in the CCA involved a taxpayer who was suggesting they certainly could have found something they could have done, the taxpayer here had previously entered into §1031 exchanges multiple times in the past to avoid taxes.

The IRS objected that this was all fine, but §1031 is simply a deferral mechanism, not ultimately a mechanism that would remove the tax. So the taxpayers were in a better position having avoided ever having to pay this tax.

However, the taxpayer had a clearly outlined plan to continue to enter into §1031 exchanges until the real property passed through an estate, at which point the basis would be stepped up. As the Court noted, this would mean that, if the plan was executed, no tax would ever be paid on the appreciation.

Thus, in this case the Court found the amount of damages related to the tax paid was not includable in the taxpayers' income.

Section: 61
Taxpayers Participating in State Gambling Treatment Program Where Any Future Winnings are Forfeited to the State Not Taxable on Winnings Forfeited

Citation: CCA 201433015, 8/15/14

The interaction of a state run gambling addiction treatment program and federal tax on reporting and taxation of gambling winnings created the need for a Chief Counsel Advice outlining the National Office's view of the proper resolution of the matter, found in Chief Counsel Advice 201433015 (http://www.irs.gov/pub/irs-wd/201433015.pdf).

The state in which a casino was located ran a program (the Voluntary Exclusion Program or VEP) that individuals who have gambling problems may enter. Such individuals agree, via a contract with the State, that they will both not enter a state casino (they agree they can be arrested for trespassing if found in one) and, as well, if they do enter a state casino they will forfeit any winnings.

Casinos are given information regarding VEP program participants and are required to consult the list of such participants whenever they are paying out jackpots. If a VEP participant's payout is confiscated, it is sent to the State for use in its gambling addiction treatment programs.

The question arose about what should a casino do if a VEP participant has winnings that would generally require the casino to issue a Form 1099G? As well, would the gambler be taxable on his/her winnings under the assignment of income doctrine in this event?

The IRS first concludes that no information return is required so long as the casino recognizes the person as a VEP participant and redirects the payment to the state. The IRS determined that the information reporting is triggered only upon a payment to an individual and, in this case, no payment is made. However, if the casino does end up failing to recognize the winner as a VEP participant and pays the winnings to that person, then the Form W2-G is required to be issued.

The IRS also concluded that this program does not run afoul of the assignment of income doctrine. The VEP participant has made an election prior to participating in the gambling activity that any winnings are going to be forfeited. The ruling finds this is a case where the taxpayer has waived all rights to the income and does not direct or retain the ability to direct the disposition of the income after it is earned and payable.

Section: 71
Despite Agreement Between Spouses That Payments Would Be Tax Alimony, Court Finds Child Based Contingency Causes Payments to Fail to Be Tax Alimony

Citation: Johnson v. Commissioner, TC Memo 2014-67, 4/14/14

If both former spouses agree a payment should be treated as alimony, that isn't the end of the issue, as the payor discovered in the case of *Johnson v. Commissioner*, TC Memo 2014-67, http://ustaxcourt.gov/InOpHistoric/JohnsonMemo.Buch.TCM.WPD.pdf.

The Tax Court in this case notes that

> The divorce decree states that the spousal maintenance should be deductible to Mr. Johnson under section 215 and includible in his ex-wife's gross income under section 71.

Mr. Johnson was to, and did, pay his former spouse \$6,068 per month plus 40% of his gross bonus each year. Eventually this number and the related child support was reduced under a court order, though the terms remained otherwise the same.

His ex-spouse reported all support payments received on her return. Originally Mr. Johnson did not claim the bonus payment as alimony, but after the IRS questioned his right to any deduction and he filed in Tax Court, he increased his claimed alimony by the 40% bonus.

Many advisers at this point would wonder how there could be a problem--after all, Mr. Johnson's ex-spouse reported the amount as income, the divorce decree provided the payments should be treated as tax alimony and Mr. Johnson paid the amount.

Well, the issue related to the clause in the agreement regarding when the payments would cease. The divorce agreement provided that Mr. Johnson's payments would terminate upon the occurrence of any of the following events:

- Remarriage of the former spouse
- Death of the former spouse
- Graduation of their youngest child from high school

The first trigger is no problem and the second is actually required to have tax deductible alimony. But the third trigger is a major problem--IRC §71(c)(2) provides that any payment that is subject to contingencies related to a child must be treated as nondeductible child support and not alimony.

Mr. Johnson did escape penalties based on reliance on a tax adviser. He took his return to a CPA to whom he provided a copy of divorce decree. The CPA, based on that information, took a deduction on the return for child support. The Tax Court found that Mr. Johnson had reasonably relied on the advice of a professional, even if that advice turned out to be erroneous.

One thing not discussed, because it doesn't impact Mr. Johnson and isn't really an issue the Tax Court would worry about, is the potential exposure of the tax adviser to the former Mrs. Johnson (assuming there was one).

While Mr. Johnson reported less taxable income than he should have, Mrs. Johnson reported income and very possibly paid tax on amounts that it turns out should not have been taxable to her. If the adviser was provided with a copy of the decree and failed to notice the issue, it's very possible that adviser could be exposed to a claim by Mrs. Johnson both for the cost of preparing claims for refund and, more of an issue, the tax she paid for years where the statute has closed for a claim for refund.

Section: 71
Significant Discrepancies Found Between Alimony Deductions and Income Inclusion by TIGTA, Additional IRS Scrutiny Recommended

Citation: Significant Discrepancies Exist Between Alimony Deductions Claimed by Payers and Income Reported by Recipients, TIGTA Report 2014-40-022 , 3/31/14

The Treasury Inspector General for Tax Administration (TIGTA) issued a study (http://bit.ly/TIGTAAlimony) on the level of non-compliance in alimony reporting and found a significant number of problems and recommended the IRS strengthen both return processing procedures and examination procedures to reduce the problem.

TIGTA found in their study of 567,887 returns filed for Tax Year 2010 that claimed an alimony deductions, in 47% of those cases the amount reported as alimony on the recipient's return was either zero or differed from that reported on the payor's return. The difference amounted to $2.3 billion of deductions claimed for which no income was reported.

TIGTA found that:

- The IRS does not examine enough returns to truly address this issue at the exam level and, in any event, have no specific procedures in place to address the problem;
- In their sample, the IRS's processing procedures failed to identify 6,500 returns in which no TIN or an invalid TIN was provided by the payor of alimony; *and*
- The IRS failed to assess penalties of $324,900 on individuals who failed to provide a TIN when claiming an alimony deduction.

TIGTA recommended that the IRS develop processes to address this gap and procedures to insure that an alimony deduction will not be allowed unless a valid TIN is supplied by the payor.

The IRS agreed generally except for the recommendation that they disallow the deduction on returns without a valid TIN. The IRS argues that they have no authority to do that outside of the deficiency procedures (that is, this is not a "math error" type of situation) and thus it must be addressed via the more involved Compliance procedures.

What advisers need to take away from this is that it is likely the IRS will, over the next few years, begin beefing up their cross-checking of alimony deductions. This is, not surprising, an area of friction between payors and recipients (simply the fact it relates to a divorce is enough to insure that) and taxpayer (and, unfortunately, sometimes their advisers) do not understand that "alimony" for federal tax purposes is not determined by what the state law may nor may not call something.

Generally to qualify as alimony a payment must meet the following criteria found at IRC §71(a):

- Payment must be received under a divorce or separation agreement;
- The agreement must not designate the payment as not included in gross income for federal tax purposes by the recipient and not deductible by the payor;
- The payee and payor must not be members of the same household at the time the payment is made; and
- Any liability for payment stops immediately upon the death of the recipient spouse

The last item is the one that most often leads to issues, as even if state law calls a payment "alimony" it won't qualify if payments must be made to the recipients estate (a result the Tax Court has found for certain items labeled under specific state laws as "lump sum" alimony).

As well, payments will not be treated as alimony if the payment is either reduced or ceases based on certain contingencies related to a child under IRC §71(c)(2). Advisers should also be aware of the potential impact of the "front end loading" rules of IRC §71(f) that may require alimony recapture in later years.

Often a tax adviser will not be consulted until well after the papers have been signed. While competent family law counsel generally provide that the client must seek independent advice on the tax impact of the agreement, clients (who are already paying fees to counsel) may resist seeking counsel from tax advisers.

The client may also be reluctant to provide the tax adviser with a copy of the divorce documents before or after they are signed, either due to concerns about fees or their own privacy. However, there is no way for a tax adviser to be able to determine whether payments paid or received are alimony without access to the documents in question—and sometimes even with access to those documents if the document is silent about what happens if the recipient spouse dies.

In that latter case where there is not a specific resolution of the issue regarding whether payments cease or do no cease on the death of the recipient, the tax adviser will need to require the client to obtain (and pay for, a hitch to the client) legal advice about how the specific state law in question would treat the obligation on the death of the recipient spouse. CPAs who are not attorneys must not decide to become family law attorneys for a day to decide these issues, at least unless they wish to end up with a potentially large liability in a malpractice claim and potential state board complaint filed by a disgruntled client following an IRS exam on the issue.

Similarly the question of "is this alimony" is a major exposure for CPAs who decide to attempt (even with the required consents under Circular 230 §10.29) to continue representing both spouses in a divorce. Unfortunately quite often agreements are far from clear on the required four issues and the adviser will not be "off the hook" if the spouses initially decide to agree that they will (or won't) treat a payment as alimony.

The problem is as follows:

- First, Circular 230 §10.34, IRC §6694 and AICPA Statements on Standard for Tax Services No. 1 do not provide an exception to their return position and signing standard rules for cases where the client decide to arbitrarily rewrite the tax law.
- A conflict of interest can only be waived by the client if both a) the CPA determines that he/she can provide diligent representation (that is, give the client all options) and b) any consent are *informed consents* (meaning that the client understands the issues that are in conflict and the risk involved in accepting advice from the CPA while that conflict is in existence)

Down the line, as relations continue to sour (and they often do), one or the other party may move on to new counsel and/or a new tax adviser who will point out that they have been overpaying taxes because the prior adviser did not properly deal with alimony.

Section: 71
IRA Account Owner Not Automatically Liable for Tax on Amounts Withdrawn from IRA When Withdraw Was Fraudulent

Citation: Roberts v. Commissioner, 141 TC No. 19, 12/30/13

Is a taxpayer liable for the tax on fraudulent withdrawals from his IRA account? And would your answer change if the taxpayer failed to take aggressive action to recover the fraudulently withdrawn amount? Those were the questions dealt with by the Tax Court in the case of Roberts v. Commissioner, 141 TC No. 19, http://www.ustaxcourt.gov/InOpHistoric/RobertsDiv.Marvel.TC.WPD.pdf.

Mr. Roberts was in the middle of divorce proceedings with his soon-to-be former wife. Although Mr. Roberts remained listed as an owner of the joint bank account with Washington Mutual, Mrs. Roberts actually control the account at this point in time. Mr. Robert had IRA accounts with custodians that were, as you would expect, in his name only.

In September of 2008 one custodian received a withdrawal request on the IRA account. The withdrawal request, signed by "Andy Roberts" and dated in a month, date, year format, came from a fax machine located at his wife's place of employment. Interestingly enough, the money also ended up being deposited in the Washington Mutual checking account that Mrs. Roberts had sole control of.

Unfortunately, Mr. Roberts was unaware of this transaction. Mr. Roberts normally signed his name "Andrew Roberts," and dated his request in the European format of day, month, year. A review of the fax form made it clear that the signature on that form was not that of Mr. Roberts.

While Mrs. Roberts claimed to be unaware of how this money had ended up in her account, the Tax Court did not find her credible. That was partially because she managed to spend all the money in the account, and she went on spending sprees shortly after the money appeared in her account. The court also found it highly suspect that these faxes came from Mrs. Roberts' place of employment.

In November a second request to a different custodian was made from the same fax machine for another withdrawal, money that again reappeared in the Washington Mutual checking account. Again the Court concluded this request was forged.

Mr. Roberts was a bit of a trusting soul. He had agreed to file a joint return with Mrs. Roberts for the year in question. He left her in charge of getting the return prepared. This turned out to be an unfortunate decision.

Rather than preparing a joint return, Mrs. Roberts prepared separate returns for each of them. The return from Mr. Roberts was prepared with single filing status. The return did not include any income from the IRA accounts, but showed a large refund due which Mrs. Roberts had deposited in the Washington Mutual bank account after she caused the return to be electronically filed.

Although Mr. Roberts asked to see a copy of what he believed was to be a joint return, Mrs. Roberts provided no copies of any return to Mr. Roberts.

Mr. Roberts did become aware that something happened to his IRA account when he received the Forms 1099R for the year in question. Originally Mr. Roberts was not aware that Mrs. Robert had been the party to misappropriate the funds, but he did become aware of that fact before the divorce proceedings were finalized. He made this fact known to the court handling the divorce, and the court took the misappropriated funds into account when dividing the couples' property.

Now the IRS enters the scene. The IRS sought to tax Mr. Roberts on the amount of the distributions from the IRA account.

The IRS first argues for taxation based on the theory that Mr. Roberts, being the owner of the account, was automatically liable for the tax due on any amounts distributed from the account. The agency goes on to argue that Mr. Roberts should be paying the tax since the funds ended up in a joint account and were used to pay some joint obligations. The IRS also notes that Mr. Roberts never attempted to return the funds to the IRA account after he discovered they had been absconded with.

The Tax Court rejected the IRS's view that there is strict liability for tax due on IRA distributions directed at the owner of the account regardless of whether the owner authorized the distribution. The court also distinguished this case from the *Vorwald* case, where the taxpayer had a child support obligation discharged by a distribution ordered by the court from the IRA. While there may have been some minor benefit to Mr. Roberts in some joint expenses that were paid from these funds, the vast majority of the funds went to Mrs. Roberts' personal use (including a trip to Disneyland and expenses of setting up a separate residence).

Thus the Tax Court concluded that Mr. Roberts was not a distributee of the IRA account in this case, a requirement for taxation under the federal tax law.

The court sidestepped the IRS's other analyses in this case. The IRS pointed out under Washington state law, since Mr. Roberts did not contest the withdrawals within a year, he had acquiesced to the withdrawals. Under the applicable state law, the custodian would not have to return the funds if Mr. Roberts did not notify them of an unauthorized withdrawal within one year.

The Tax Court did not directly address this issue. Rather, the court pointed out that the expiration of the one year period would have been after the tax year in question. Thus, Mr. Roberts' acquiescence would have occurred in 2009 and not 2008. Since Mr. Roberts' tax for 2008 was what was before the court, the issue therefore became irrelevant for the year the court was dealing with.

The court did not rule on whether Mr. Robert would be taxable in either 2009, when he acquiesced to the transfer, or in 2010 when the divorce became final. The answer to that question would have to await another IRS assessment.

Section: 71
Modification to Divorce Decree Manages to Make Payment to Settle Alimony Issues No Longer Alimony for Tax Purposes

Citation: Nye v. Commissioner, TC Memo 2013-166, 7/15/13

The case of Nye v. Commissioner, TC Memo 2013-166, (http://www.ustaxcourt.gov/InOpHistoric/NyeMemo.Chiechi.TCM.WPD.pdf), the question of whether a payment represented deductible alimony faced the court. That, in and of itself, is not unusual—the Court often ends up having to deal with this issue, often due to lack of clarity in the original divorce agreement.

However, in this case the original agreement was clear that amounts being paid were alimony. All of the basic requirements to have payments classified as alimony were met. Specifically, the agreement provided that payments would terminate upon the death of the recipient.

However, eventually the parties went back to court to attempt to modify the agreement. In mediation they came to an agreement where the paying spouse would pay a single lump sum to discharge his entire obligation to the recipient.

In December of 2007 they came to this agreement, which provided that if he paid his former spouse $350,000 by a date in March of 2008, his entire alimony obligation would be discharged. The payment was made in 2008 and the taxpayer claimed the entire payment as alimony income.

The IRS disagreed that the modification represented alimony. The Tax Court agreed with them by analyzing the issue that most often comes back to haunt former spouses making payments—the question of whether the payment would have been due had the recipient spouse died before the payment was made.

The mediation agreement did not address that question. When agreements don't address the matter, the Tax Court attempts to discover what state law would provide. In this case the court did find a similar case where the recipient did die before the payment was made, and her estate's representative sued to force the modification to move forward.

The Tax Court noted that while the Florida courts eventually ruled that no modification could be made following the death of the recipient, nevertheless the estate could look to state contract law to attempt to force the payment. While the Florida court decision did not address whether, in the case in front of it, there was such a contract right (the estate had only argued for the modification to be made) the Tax Court reviewed Florida law and concluded such a claim would succeed.

Thus, the Court found, the December 2007 agreement created an obligation to pay on the part of the taxpayer that would have survived the death of the recipient prior to the deadline for payment. As such, the payment did not constitute alimony under state law.

As this ruling dealt with the specifics of Florida law, it cannot be directly applied to such an agreement executed in any other jurisdiction. But what can be gleaned from this case is the importance of clarity in any modifications being proposed to a divorce agreement.

Specifically, it is almost always better, from a tax standpoint, if the agreement clearly states whether or not a payment obligation would survive the death of the recipient spouse. Doing so forces the issue of whether a payment will or will not be treated as alimony for federal tax purposes.

Section: 104
Settlement in Dispute Over Disability Benefits on Policy Paid for by Employer Not Excludable from Income

Citation: Ktsanes v. Commissioner, TC Summary Opinion 2014-85, 9/2/14

The mere fact that a physical disability is involved in a legal dispute does not automatically mean that the taxpayer can exclude from income an award or settlement, as the taxpayer discovered in the case of *Ktsanes v. Commissioner*, TC Summary Opinion 2014-85.

Mr. Ktsanes was diagnosed with Bell's palsy, which rendered him unable to work. He was employed by a community college district at the time, and the district provided Mr. Ktsanes with coverage under a disability policy which that was paid for at the district's expense.

He applied for and received short-term disability benefits from March through June of 2006, at which time his employment with the district ended. In November he applied for long-term benefits from the insurance carrier. In March of 2007 the carrier denied him the long-term benefits, holding that he was not totally disabled.

Eventually Mr. Ktsanes filed suit to obtain benefits he claimed was due to him. In December 2009 Mr. Ktsanes entered into a settlement for $65,000. The settlement provided that the amount paid would be reported as long-term disability benefits to the IRS under the policy.

IRC Sections 104(a)(1), (2) and (3) provide the following:

> (a) In general
>
> Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include -
>
>> (1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;
>>
>> (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;
>>
>> (3) amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer);

Mr. Ktsanes argued that his payment should be excludable under Section 104(a)(2) as a payment for physical illness and, in any event, would otherwise be excludable under Section 104(a)(1) as a worker's compensation payment.

The Court determined the taxpayer was mistaken in both cases. On the issue of physical illness the Court noted that the allegation was that the insurance company had violated its contractual obligation and it paid the damages in satisfaction of a claim for failure to perform under the contract. None of the damages paid were for a claim of physical injuries or illness—rather it was for a failure to pay disability benefits that the company had contracted to pay.

As well, the Court noted that in California (the state in question) a workers compensation settlement must be approved by the California Workers' Compensation Appeals Board (WCAB). The taxpayer admitted he did not submit the settlement to that board for approval, thus the payment was not received under the state's workers compensation act.

Although the taxpayer did argue for exclusion based on IRC §104(a)(3) the Court addressed it anyway. The Court noted that the payments were payments under an insurance policy for sickness on a policy paid for by the employer and whose premiums were not included in the employee's income. In such a case, the payment is includable in the employee's income.

Section: 104
Payment to Settle Potential Workers Compensation Claim Not Excludable Because Did Not Follow State Statutory Requirements

Citation: Simpson v. Commissioner, 141 TC No. 10, 10/28/13

The Tax Court had to deal with the question of whether a lawsuit settlement that dealt primarily with claims of emotional distress and physical and mental disabilities, and which also had an issue raised regarding a workers compensation claim, could be excluded from income under IRC §§104(a)(1) and/or (a)(2). [Simpson v. Commissioner, 141 TC No. 10, http://www.ustaxcourt.gov/InOpHistoric/SimpsonDiv.Laro.TC.WPD.pdf]

The taxpayer in question claimed in her lawsuit to have suffered physical and mental disabilities due to her work assignments in California. The defendant moved for summary judgment on all issues in the original claim, and the California state court granted the request on all but one issue.

The plaintiff's attorney concluded, after studying the court's reasoning, that his client could not prevail on the remaining issue either. However, the attorney discovered that his client had a potential claim under California's workers compensation law and that the defendant had failed to give proper notice of her rights, subjecting the employer to a significant claim.

The attorney informed defense counsel of this issue, and the parties arrived at a $250,000 settlement. $12,500 of the settlement was paid to Ms. Simpson as compensation for lost wages. Of the remainder, $152,000 went to Ms. Simpson's attorney for his fees and court costs, with the $98,000 left over given to Ms. Simpson to settle all other claims. Her attorney concluded that this payment was to compromise her claim for workers compensation and that 10%-20% of the amount was to pay Ms. Simpson for work-related illness and disabilities.

Ms. Simpson reported only the $12,500 of the settlement as taxable. The IRS argued the entire balance was taxable. The Tax Court concluded mainly in favor of the IRS in total, though two out of the three arguments were found in favor of Ms. Simpson.

The biggest loss came on the 80% of the $98,000 that was deemed to be treated as compensation for the workers compensation claim. While the Court agreed that, despite documentation problems, the payment was clearly meant to settle the workers compensation issue, that isn't enough to exclude the item from income under the §104(a)(1) exclusion for payments on a workers compensation claim.

IRC §104(a)(1) talks about excluding payments made under a workers' compensation act and Judge Laro comments "[t]o qualify for the exclusion, a taxpayer must show that she received her benefits under a statute or a regulation." However, the settlement failed to meet the strict requirements under applicable state law (California in this case) required to settle such a claim. Specifically, California law requires any such settlement be submitted to the California Workers' Compensation Appeals Board (WCAB) for approval. This settlement was not submitted to the WCAB for approval.

However, the Court did find that 10% of the $98,000 settlement payment was for physical injuries, excludable under IRC§104(a)(2). The Court noted that the record was clear that there such physical injuries and the settlement was to some extent to compensate for such injuries. While no exact amount was stated, the Court estimated 10% of the $98,000 to present such excludable damages.

The Court also allowed a deduction for the $152,000 paid to Ms. Simpson's attorney. The IRS objected to $38,014.40 of that deduction because the attorney only accounted for fees that fell that much short of the $152,000. However, the attorney testified that the difference represented court costs and Judge Laro found him credible, in addition to noting Ms. Simpson executed an agreement paying the attorney that amount.

Section: 107
Seventh Circuit Reverses Housing Allowance Constitutionality Decision on Grounds Plaintiffs Lacked Standing to Sue, Invites Another Round of Litigation

Citation: Freedom from Religion Foundation, Inc. v. Lew, 114 AFTR 2d, ¶2014-5425, 11/13/14

In what was probably not a surprising development, the Seventh Circuit Court of Appeals in the case of *Freedom from Religion Foundation, Inc. v. Lew*, 114 AFTR 2d, ¶2014-5425 decided that the plaintiff in the case had no standing to bring the suit in question, thus the District Court's ruling became irrelevant.

The result is not surprising because, clearly, the Court understood the original ruling had generated a lot of attention outside of the tax community and, by going the standing to sue route, the Court simply made the issue go away without having to deal with the underlying analysis in the original District Court decision. However, the way the Court did so invites a second round of litigation in this area.

What was the issue? Well, as the name of the plaintiff might suggest, the individuals involved with the organization are, shall we say, no big fans of religious institutions and were upset at the parsonage exemption under IRC §107. They argued that the provision was an unconstitutional provision, providing a violation of the First Amendment's prohibition on the establishment of a religion by the federal government.

In order to proceed with a suit in court, a plaintiff must show that he/she has standing to bring the complaint. Absent that standing, the court does not have the right to decide the issue being brought in the complaint.

IRC §107 provides:

> In the case of a minister of the gospel, gross income does not include--
>
> > (1) the rental value of a home furnished to him as part of his compensation; or
> >
> > (2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.

The taxpayer in this case had two employees (also plaintiffs in the case) who received a housing allowance as part of their compensation package. Not being ministers of the gospel (the organization is one for athiests and agnostics) the organization included the amount in the compensation of the employees and they paid income taxes on the amount.

The taxpayers brought suit claiming that they had been unconstitutionally denied the benefits of §107(2). However, note that they had included the amount as compensation on their original return and had not filed a claim for refund with the IRS prior to bringing the suit.

A footnote to the Seventh Circuit's opinion noted that the taxpayers could (and, as it turns out in the view of the panel, should) have taken certain steps before coming before this panel:

> The plaintiffs could have sought the exemption by excluding their housing allowances from their reported income on their tax returns and then petitioning the Tax Court if the IRS were to disallow the exclusion. 26 U.S.C. § 6213(a). Alternatively, they could have adopted the approach taken by the plaintiff in *Texas Monthly, see* 489 U.S. at 6, and paid income tax on their housing allowance, claimed refunds from the IRS, and then sued if the IRS rejected or failed to act upon their claims. *See* 26 U.S.C. § 7422; 28 U.S.C. § 1346(a)(1).

The Court noted this was a fatal flaw in its view, holding:

> The plaintiffs here argue that they have standing because they were denied a benefit (a tax exemption for their employer-provided housing allowance) that is conditioned on religious affiliation. This argument fails, however, for a simple reason: the plaintiffs were never denied the parsonage exemption because they never asked for it. Without a request, there can be no denial. And absent any personal denial of a benefit, the plaintiffs' claim amounts to nothing more than a generalized grievance about § 107(2)'s unconstitutionality, which does not support standing. *Lujan*, 504 U.S. at 573–74 ("[A] plaintiff raising only a generally available grievance about government ... does not state an Article III case or controversy."). In other words, the mere fact that the tax code conditions the availability of a tax exemption on religious affiliation does not give a plaintiff standing to challenge that provision of the code. A plaintiff cannot establish standing to challenge such a provision without having personally claimed and been denied the exemption.

The panel rejected the District Court's holding that filing the claim would merely be an unnecessary waste of time, citing a Fourth Circuit opinion in *Finlator v. Powers*, 902 F.2d 1158 (4th Cir. 1990).

As the ruling held:

> Insofar as the district court and the Fourth Circuit in Finlator suggest that asking for and being denied a tax exemption should not be a requirement for establishing standing because doing so would be a waste of time, we cannot agree. Perhaps these courts are correct that requiring the plaintiffs to request and be denied the parsonage exemption will be a "futile exercise," Freedom from Religion Found., No. 11cv0626, at 8–9, that will not improve the court's ability to resolve the constitutional challenge, but this is beside the point. The Constitution does not allow federal courts to hear suits filed by plaintiffs who lack standing, and standing is absent here because the plaintiffs have not been personally denied the parsonage exemption. Article III "is not merely a troublesome hurdle to be overcome if possible so as to reach the "merits" of a lawsuit which a party desires to have adjudicated; it is a part of the basic charter promulgated by the Framers." *Valley Forge*, 454 U.S. at 476.

The opinion made very clear at the start that the opinion did not deal with "the issue of the constitutionality of the parsonage exemption."

So while the original case result is reversed, it seems likely that the taxpayers may take the Seventh Circuit up on its instructions to go ahead and file for a refund. Assuming the IRS does disallow their claimed refunds, it seems likely that the same issue will again come before the Courts sometime in the near future.

Of course, if the taxpayers receive their requested relief (an exemption from tax for their housing allowance) that wouldn't mean that ministers would face retroactive taxation. But it seems likely that Congress might decide to act if the decision was one that granted all individuals a "housing allowance" type benefit. The impact of such changes is what potentially could be a negative impact for ministers in the tax arena.

Section: 107
Minister and Church Not Allowed to "Clarify" Employment Agreement to Designate Housing Allowance After the Fact

Citation: Williams v. Commissioner, TC Summary Opinion 2013-60, 7/22/13

In the case of Williams v. Commissioner, TC Summary Opinion 2013-60 (http://www.ustaxcourt.gov/InOpHistoric/WilliamsSummaryPanuthos.SUM.WPD.pdf) the Court reminds us that you can't backdate documents to achieve results when the Code and/or regulations require actions to be taken on or before a particular date.

In this case the issue revolved around a minister's housing allowance. Generally, under IRC §107(2) a minister may exclude "the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities."

The regulations under §107 impose a requirement that such an allowance must be properly designated by the governing body of the church in question. Specifically Reg. §1.107-1(b) provides:

> The term "rental allowance" means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as rental allowance pursuant to official action taken…in advance of such payment by the employing church or other qualified organization when paid after December 31, 1957. The designation of an amount as rental allowance may be evidenced in an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action. The designation referred to in this paragraph is a sufficient designation if it permits a payment or a part thereof to be identified as a payment of rental allowance as distinguished from salary or other remuneration.

The minister in question had signed an initial employment agreement with the church in September 2005 that provided the church would pay the minister a housing allowance of $500 per month for six months. This agreement was not modified up through the year under exam (2007) and there was no indication that the church had documented an intent to extend the $500 payment or otherwise designate any amount of the compensation as related to the housing allowance after the six month period expired.

The minister, however, continued to count an amount of his compensation as housing allowance. The IRS pointed out the problem on examination.

The minister and the church executed a second employment agreement. They dated the agreement 2005, but it was actually executed in 2012. The agreement purported to "clarify" the original employment agreement and now provided the amount claimed by the minister was housing allowance.

The Tax Court held that an agreement executed in 2012 could only modify payments made after that date, as a housing allowance designation must be made before the amounts in question are paid. Thus, the minister's attempt to exclude a portion of his compensation as housing allowance for 2007 was denied.

Advisers who counsel ministers or those who serve on boards of church organizations should emphasize the importance of getting the details right on the matter of any housing allowances. Such boards and the ministers may not always realize that seemingly "minor" details matter here, and that a failure to follow proper procedure will eliminate the ability to exclude the income.

Section: 108
Debt Secured by Different Residence Not Acquisition Debt for Qualified Home Mortgage Debt Exclusion

Citation: Koriakos v. Commissioner, TC Summary Opinion 2014-70, 7/16/14

Among many issues at dispute in the case of *Koriakos v. Commissioner*, TC Summary Opinion 2014-70, http://www.ustaxcourt.gov/InOpHistoric/KoriakosSummary.Armen.SUM.WPD.pdf, was one that was slightly unique—the application of the short term exclusion from income of cancellation of debt related to qualified principal residence indebtedness per IRC §108(a)(1)(E) when the debt used to purchase the taxpayer's principal residence was actually secured by another residence.

The taxpayers had a home in Arizona on which they obtained a line of credit. They drew on that line of credit and used it, along with other money to purchase a home in Florida which became their principal residence. Later the Arizona home was foreclosed upon, and the line of credit debt was cancelled by the original lender who issued a Form 1099-C for the balance of the credit line.

The taxpayer argued that since they used the borrowed funds to purchase their Florida home, a home the IRS conceded was their principal residence, that they were not taxable on that debt per IRC §108(a)(1)(e). The Court noted that the provision in §108 cross references IRC §121 for the principal residence, and that is the residence which is treated as the qualified residence for this purpose.]

However, the definitions for acquisition debt under IRC §163(h)(3)(B), also cross referenced as part of the definition, requires acquisition debt to be secured by the qualified residence. In this case the debt was secured by another residence of the taxpayer. Thus, no exclusion from income was available under §108.

Section: 108
Mortgage to Acquire Adjacent Co-operative Unit and Then Combine with Taxpayer's Unit Considered Part of Acquisition Debt for Principal Residence

Citation: PLR 201328023, 7/12/13

We know that debt incurred to acquire a principal residence or substantially improve it is considered acquisition indebtedness under §163. But in PLR 201328023 (http://www.irs.gov/pub/irs-wd/1328023.pdf) a unique situation presented itself.

In this case the taxpayer owned an apartment in a cooperative that was used as the taxpayer's principal residence. The taxpayer acquired a new mortgage that was used to acquire the adjacent apartment in the co-op, and well as make structure changes to enable free movement between the two units and to effectively combine them into a single larger unit. Following completion of the rennovations the taxpayer used the combined units as a principal residence.

The question was whether the acquisition of what would have qualified as a separate residence was turned into acquisition debt on the original residence, or whether this was other debts.

The IRS found that the situation was analogous to having built an addition on the original unit, activities that would qualify as a substantial improvement. Thus the entire amount was considered to be acquisition indebtedness on the taxpayer's principal residence.

Astute observers may wonder at first blush why this seemed important—after all, the taxpayer is allowed to deduct interest on both a principal residence and a second residence, thus so long as the taxpayer didn't have yet another residence it seems as if the ruling was unnecessary—the taxpayer would get to deduct interest on both loans as acquisition indebtedness under §163.

The matter was key because the property plunged in value. The taxpayer approached the lender to see if the lender would agree to compromise the debt for a one time payment of less than the outstanding balance of the debt. The lender agreed to that, creating a cancellation of indebtedness on the debt.

Under §61(a)(12) such cancellation is income. However, under IRC §108(a)(1)(E) cancellation of debt on a mortgage on the taxpayer's principal residence is excludable to the extent the amount represents solely acquisition indebtedness on a taxpayer's <u>principal</u> residence and does not exceed $2 million. If the debt consists of both such debt and other debt, the cancellation is assumed to first come from the non-qualified debt—so the second residence rule would not have been of use to the taxpayer here.

Advisers should also note that this ruling would allow the taxpayer to claim mortgages on both units in this case and still have the ability (within the $1 million acquisition debt limit) to claim an acquisition indebtedness deduction on another property used as a second residence.

Although the ruling dealt with mortgages on cooperative stock that represented rights to the unit, the same result should arise for a taxpayer combining adjacent condominium units. Both properties are considered, under the IRC, to qualify as residences.

Section: 117
Community Service Requirements Did Not Cause Scholarship Proceeds to Be Taxable to Recipients

Citation: PLR 201328020, 7/12/13

In PLR 201328020 (http://www.irs.gov/pub/irs-wd/1328020.pdf) the IRS ruled on whether conditioning the awarding of scholarships on the performance of certain community services would be treated as disqualifying the recipients of the scholarships from excluding them from income under IRC §117.

The program in question identifies potential recipients in grades 8 through 12 who are nominated by unrelated partner agencies to the granting organization. The program establishes minimum scholarship and community service requirements and participants who meet these requirements are awarded college scholarships. 50% of the community service is in any capacity of the participant's choosing, with the other 50% having to be provided to partner organizations through public service programs.

IRC §117(c) provides that the exclusion does not apply to "payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship or qualified tuition reduction." The question raised by the organization was whether their community service requirements are "other services" being rendered as a condition of the scholarship.

The IRS ruled that this is not the case. The agency notes that ½ of the service is wholly under the control of the recipient and not directly or indirectly for the benefit of the granting organization. The IRS also found that the 50% that had to be served in the identified projects did not provide a direct benefit to the granting organization.

Thus the IRS concluded that the recipients would not have to report the value of the scholarships as income, being able to exclude them under IRC §117.

Section: 121
Gain on Repossession of Prior Residence Computed Under §1038 Not Eligible for §121 Exclusion, Taxpayer Taxed on All Cash Received

Citation: Debough v. Commissioner, 141 TC No. 17, 5/20/14

By repossessing a personal residence the taxpayer had sold by taking an installment note, the taxpayer ended up losing access to the IRC §121 $500,000 exclusion of gain on the sale of a principal residence in the case of Debough v. Commissioner, 141 TC No. 17, http://ustaxcourt.gov/InOpHistoric/DeBoughDiv.Nega.TC.WPD.pdf.

The case deals with the interplay of IRC §121 (the exclusion for the gain on the sale of a qualifying residence) and IRC §1038 (a provision that is meant to offer relief when a taxpayer repossesses real property). Effectively the Tax Court concluded that IRC §1038's provisions trump the relief provision of IRC §121 in this fact pattern.

Generally if a taxpayer exchanges a note for property that's an exchange of assets. Exchanges, absent special rules, are treated in the same manner as a sale, with the fair value of the asset received being treated as the sale price of the asset sold.

Under the general rule a taxpayer repossessing real estate would compare the taxpayer's basis in the installment note with the fair value of the property received, recognizing gain or loss on the exchange subject to any other special tax rules.

Under §1038 is a special rule that applies when a taxpayer repossesses real property in satisfaction of a note that secured the real property. In that case gain or loss on repossession is ignored, but with a major caveat—the taxpayer must recognize gain to the extent of any cash or other property received as payments on the note prior to the repossession, reduced by any amount previously recognized as taxable gain. The goal is to put the taxpayer back where he/she was "taxwise" prior to the sale, but giving credit to (and taxing) the cash received since the taxpayer did receive that along with getting back the property.

A special rule is found at IRC §1038(e) that provides if the property in question was the taxpayer's principal residence and §121 applied to the original sale, if the taxpayer resells the reacquired property within one year then the gain rules do apply generally, but rather the resale is simply treated as part of the original sale of the property.

In the case before the Tax Court, though, the property was not resold within one year of reacquisition (something not terribly surprising in the generally down residential real estate market of 2009, the year in question). So the question became how the matter should be treated in this case.

The taxpayer argued that they should be able to apply the $500,000 gain exclusion to the §1038 gain calculation and thus only recognize collections in excess of $500,000 as gain (and, in this case, there were such collections). The taxpayers argue that the existence of §1038(e) indicates Congress was aware of the interplay of the provisions and offered a limited response for that special case so "additional gain" on the second sale could still be excluded.

The IRS disagreed about the import of §1038(e). To the IRS the existence of this provision agrees Congress was aware that there are two sections here, but the limited application of §1038(e) means that unless that provision is triggered (by disposing of the property within one year after reacquisition) the general rules of §1038 should apply and, being this is not gain on the sale of a residence but rather "§1038 gain" that §121 is not applicable.

The Tax Court sided with the IRS. The Court noted:

> Whatever the reasoning behind the exception, the relief offered by section 1038(e) is clearly limited to those sellers who resell their principal residences within one year of reacquisition. Since petitioner did not resell the property within one year of reacquisition, he is ineligible for the section 1038(e) exception and must recognize gain in accordance with the general rules of section 1038.

The Court notes that, under traditional rules of statutory construction, the existence of a specific exception to a general rule implies that Congress intended to exclude any further exceptions that it did not explicitly provide for.

The Court finds this consistent with the economics of the situation noting:

> Petitioner received $505,000 in cash before the reacquisition of his former principal residence. Petitioner has received "money" as defined within section 1038(b) that exceeds gain previously returned as income on the sale of the property during periods before the reacquisition. We see nothing unfair in the Code's taxing petitioner on receipt of this income, as he is actually in a better position than he was before the sale by virtue of having ownership over both the property and $505,000.

The taxpayer, most likely receiving property with a much lower fair value than it had when it was originally sold, might not see the issue the same way. But, regardless, the taxpayer ends up with a bill for tax due on $505,000 less the gain the taxpayer had previously recognized on the installment sale.

Section: 131
Medicaid Home and Community-Based Services Waiver (Medicaid waiver) Program Payments To Certain Providers Excludable From Income

Citation: Notice 2014-7, 1/3/14

In Notice 2014-7 (http://www.irs.gov/pub/irs-drop/n-14-07.pdf) the IRS announced a change in its position with regard to the taxation of payments received by certain individual care providers under a state Medicaid Home and Community-Based Services Waiver (Medicaid waiver) program.

Such programs pay individuals for personal care services for individuals that otherwise would require care in a hospital, nursing facility, or intermediate care facility. These services are ones that are other than those that only a health professional may perform. These services include assistance with eating, bathing, dressing, toileting, transferring, maintaining continence, personal hygiene, light housework, laundry, meal preparation, transportation, grocery shopping, using the telephone, medication management, and money management.

The IRS had previously taken the position that such payments made to an individual related to the care recipient were taxable income. There is an exclusion available in IRC §131 for payments to foster care provider. However, the IRS has taken the position that similar payments to a related person are not foster care payments, including in Program Manager Technical Advice PMTA 2010-007. In 2011 the IRS carried this position with regard to such payments in the case of *Alexander v. Commissioner*, TC Summary Opinion 2011-48.

The ruling provides that effective January 3, 2014 the IRS will treat payments under a state Medicaid Home and Community-based Services Waiver program to an individual care provider for nonmedical support services provided under a plan of care to an eligible individual (whether related or unrelated) living in the individual care provider's home as foster care payments under IRC §131.

The notice cautions:

> This notice does not address whether qualified Medicaid waiver payments excluded from income under this notice may be subject to tax under the Federal Insurance Contributions Act (FICA) or the Federal Unemployment Tax Act (FUTA) in certain circumstances.

While the notice applies prospectively, it goes on to note that taxpayers may apply this retroactively to any year for which a claim for refund is still available.

Section: 139
West Africa Countries Affected by Ebola Virus Disease Outbreak Designated as §139 Qualified Disaster

Citation: Notice 2014-65, 10/29/14

The IRS has announced that the Ebola Virus Disease (EVD) outbreak occurring in the West Africa countries of Guinea, Liberia, and Sierra Leone is a qualified disaster under IRC §139 in Notice 2014-65.

Under that provision of the IRC, payment of qualified disaster relief to assist victims affected by the EVD outbreak in those countries is excludable from the individual's income.

Under IRC §139(b) such qualified relief is defined as:

- To reimburse or pay reasonable and necessary personal, family, living, or funeral expenses (not otherwise compensated for by insurance or otherwise) incurred as a result of a qualified disaster, or

- To reimburse or pay reasonable and necessary expenses (not otherwise compensated for by insurance or otherwise) incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster.

Section: 152
Fact Mother Named Custodial Parent in Divorce Decree Not Relevant to Dependency Exemption When Child Spent More Nights with Father

Citation: Davis v. Commissioner, TC Memo 2014 147, 7/24/14

In the case of *Davis v. Commissioner*, TC Memo 2014-147, http://www.ustaxcourt.gov/InOpHistoric/DavisMemo.Thornton.TCM.WPD.pdf, the IRS mistakenly believed the fact that a divorce decreed named the other parent as the custodial parent meant that Patrick Davis could not claim his daughter as a qualifying child and obtain an earned income credit based on having her as a dependent.

Mr. Davis was divorced from Sandra Johnson Davis in 1997, and in 2000 a court gave custody of their two children to Sandra. One child, Ashley, turned 20 in 2010 and was a full-time student. In 2010 she lived with Patrick Davis's mother (her paternal grandmother). Mr. Davis also resided with his mother.

The IRS challenged Mr. Davis for claiming Ashley as a dependent. However, regardless of what a state court decree may say, federal law determines dependency status. Mr. Davis had claimed Ashley was a qualifying child. As the court pointed out:

> Generally, a "qualifying child" must: (1) bear a specified relationship to the taxpayer; (2) have the same principal place of abode as the taxpayer for more than one-half of the taxable year; (3) meet certain age requirements; (4) not have provided over one-half of his or her own support for the year in question; and (5) not have filed a joint return (other than a claim for refund) with a spouse. Sec. 152(c)(1).

The IRS contended that while Patrick Davis met the first and last requirement, he failed to meet the other three requirements and thus Ashley was not his qualifying child.

The Court addressed the question of meeting the tests by noting the IRS was mistaken in its assumptions here. As the Court held:

> The Louisiana court judgment named Ashley's mother as her custodial parent. Apparently for that reason, respondent contends that petitioner was a noncustodial parent in 2010 and so cannot claim Ashley as his qualifying child because he did not attach to his 2010 return a written declaration from Ashley's mother waiving her right to claim Ashley as her dependent, as respondent contends section 152(e) required. Respondent is mistaken. The special rule of section 152(e) is inapplicable because, if for no other reason, in 2010 petitioner was in fact Ashley's custodial parent within the meaning of the statute. A custodial parent is defined as "the parent having custody for the greater portion of the calendar year." See sec. 152(e)(4)(A).

The regulations simply "count the nights" to determine a custodial parent status, and don't look to who was awarded such status if, in fact, the child did not reside with that person. [Reg. §1.152-4(d)(1)]

Even though Ashely did not reside at a residence owned or rented by Mr. Davis, the Court noted:

> According to the regulations, a child is treated as residing with a parent for a night if: (1) the child sleeps at the residence of the parent or (2) if the child sleeps in the company of the parent when the child does not sleep at a parent's residence. Sec. 1.152-4(d)(1)(i) and (ii), Income Tax Regs. Because Ashley resided with petitioner at her grandmother's house more than half of 2010, petitioner was the custodial parent and was not required to attach a written declaration to his return.

The opinion goes to note that the evidence shows that Ashley received over ½ of her support from the family members and, by virtue of being a full-time student, met the age requirements even though she was age 20.

The Court did note one potentially significant issue that was not raised—that is, given Ashley's age, could she really have a custodial parent. In a footnote the court noted that it seemed very possible that since Ashley was over age 18, she would be emancipated under state law and thus not technically in the custody of either parent. But the Court noted that the parties hadn't raised this issue and so the Court did not consider its impact.

Section: 152
Eighth Circuit Sustains Tax Court View That a Conditional Award of Dependency Exemption in Divorce Decree, Standing Alone, Will Never Serve to Allow Noncustodial Parent a Dependency Exemption

Citation: Armstrong v. Commissioner, CA8, 113 AFTR 2d 2014-1303, 2014 PTC 133, 3/13/14

The Eighth Circuit Court of Appeals turned away a taxpayer's attempt to argue that a noncustodial parent should be able to use a divorce decree to support a claim for a dependency exemption even if the decree isn't absolutely unconditional. In the case of *Armstrong v. Commissioner,* CA8, 113 AFTR 2d 2014-1303, 2014 PTC 133, http://media.ca8.uscourts.gov/opndir/14/03/131235P.pdf.

In the case in question the divorce decree provided that Mr. Armstrong, the non-custodial parent, would be allowed to claim his son as a dependent for the year so long as he was current in his child support. Mr. Armstrong claimed his son, but did not submit a Form 8332 to his return, rather attaching a copy of the divorce decree.

The IRS agreed that Mr. Armstrong was current on his child support obligation, but argued that unless the custodial parent signed a form indicating that she would not claim the child (as would be true with a Form 8332) Mr. Armstrong could not claim the dependency exemption on his return. Mr. Armstrong's former spouse did not provide him with a Form 8332 for the year in question.

The Court noted that IRC §152(e)(2)(A) specifically requires that the "custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year" and that such a document must attached to the noncustodial parent's return.

The panel found that a conditional release cannot meet the requirement that the custodial parent declare that he/she will not claim the child as a dependent. While his ex-spouse should not claim the child (at least per their agreement) that's not the same as saying she will not claim the child.

Unfortunately it's not that unusual for former spouses to have "strained" relationships and for cooperation to be withheld for various reasons, even if such cooperation is required under the terms of the decree. The only recourse for someone like Mr. Armstrong is to bring an action against his/her ex-spouse in state court to seek redress, preferably by having the custodial parent ordered to sign the Form 8332.

But the Tax Court (now with the backing of the Eighth Circuit) has consistently held that the federal courts will not interpret the divorce decree to award the exemption, no matter what evidence the taxpayer may be able to provide to demonstrate that he/she has met the conditions in question.

Section: 152
Pre-2008 Divorce Decree Can Be Adequate to Serve as Release of Exemption by Custodial Parent, Though Not For This Taxpayer

Citation: Swint v. Commissioner, 142 TC No. 6, 2/25/14

In the case of *Swint v. Commissioner*, 142 TC No. 6, (http://ustaxcourt.gov/InOpHistoric/SwintDiv.Ruwe.TC.WPD.pdf) the Tax Court clarifies (or you might say corrects) a statement made in an earlier Tax Court case. The issue involves the use of a divorce decree standing alone, rather than a Form 8332, to serve as a release of the dependency exemption by the custodial parent.

Reg. §1.152-4(e)(1)(ii) generally provides that, for taxable year beginning after July 2, 2008 that a court decree will not serve as a release of the dependency exemption, effectively requiring the execution of a Form 8332 by the custodial parent. In the case of *Armstrong v. Commissioner*, 130 TC 468 the Court, in deciding a case involving 2007, had remarked in a footnote:

> For taxable years starting after July 2, 2008, a court order signed by the custodial parent will not satisfy 26 C.F.R. section 1.152- 4(e)(1)(ii), Income Tax Regs. *** ("A written declaration not on the form designated by the IRS must conform to the substance of that form and must be a document

> executed for the sole purpose of serving as a written declaration under this section. A court order or decree or a separation agreement may not serve as a written declaration").

In May of 2003, in a 2009 case, the Tax Court in *Shenk v. Commissioner*, 140 TC 10 the Court again reference this "rule" regarding post-2008 tax years.

In the case at hand, Linda Swint was relying on a divorce decree for tax year 2009 to claim the exemption as a noncustodial parent. The IRS, citing the above, argued that such a document simply cannot be used for post-2008 tax years.

However, the Court pointed out that Reg. §1.152-4(e)(5) provides that a divorce document that was executed in a tax year beginning on or before July 2, 2008 that satisfied the requirements at that time could continue to be used in later years.

The Court explained that the footnote quoted above from *Amstrong* was *dicta*—that is, a portion of the opinion that was not relevant to the actual holding of the case (the year in question was 2007), and thus was not a portion of the opinion that represented binding guidance. Although the *Shenk* case did involve a post-2008 tax year, the Court actually decided the case on other grounds—so, again, the commentary represented *dicta*.

In *Swint* the Court clarified that, in fact, a divorce decree that met the old regulation's criteria that was in place before the new regulations will be tested under the old rules. In such a case, so long as the decree meets all of the criteria in place at that time.

Unfortunately for *Linda Swint* (and many others in a similar position) her decree failed this test. First, the State court order in question was not signed by the custodial parent and the law required that the custodial parent must sign the release.

Second, the release of exemption was conditioned on remaining current on child support obligations. The law requires an unconditional release of the exemption, thus any conditions placed on the release in the document (again, some that is seen more often than not) will also cause the document.

So while a pre-2008 decree can serve as a release for a current year, the document the taxpayer had in this case is not a decree that will meet that test.

Section: 162
Property Was No Longer (if Ever) a Rental Trade or Business, Interest Only Potentially Deductible as Home Mortgage Interest

Citation: Hume and Dilana v. Commissioner, TC Memo 2014-135, 7/7/14

In the case of Hume and Dilana v. Commissioner, TC Memo 2014-135, http://www.ustaxcourt.gov/InOpHistoric/HumeMemo.Wherry.TCM.WPD.pdf, the key question was whether the taxpayers had a rental activity in the years in question which could enable them to claim a deduction for mortgages related to a particular property.

The taxpayers purchased a property in San Clemente, California of minor historic significance (the property had been constructed for Oscar nominated actress Ann Harding in 1926) with a view towards renting out the property for weekly vacations and events. The property had tenants living in it in 2005 at low rent, and the couple evicted them.

However they quickly discovered the property had a number of problems and issues. As well their marriage began to go downhill and in 2006 Mr. Hume moved out of their home and the parties eventually divorced in 2008.

In the years before the court Mr. Hume had lived in the property when he was not traveling, having moved out of the family's main home.

The Court had to decide if the operation was a trade or business of renting the property. In doing so the court outlined three criteria that would need to be met to find that they had a business:

- Did they undertake the activity with the intention of making a profit? The court found that they satisfied this criteria, as there was no evidence they entered it for any reason other as a money making activity.

- Was the taxpayer regularly and actively involved in the activity? The Court granted that it was plausible that this criteria was met.

- Has the taxpayer's activity actually commenced? This was where the Court found the taxpayers fell short of the standard (and likely why the court was not concerned about delving too deeply into the question of whether the "regularly and active" test was met.

The problem, the court found, was that it was clear by the years in question (2008 and 2009) that the taxpayer was living in the home, actions that were no longer consistent with the view that a rental activity was underway. In essence, if one had been started in earlier years, by 2008 it had been abandoned.

Section: 163
No Interest Deduction Allowed for Accrued Interest on Mortgage Refinanced with Same Lender

Citation: Copeland v. Commissioner, TC Memo 2014-226, 10/30/14

Following the real estate crisis of the latter half of the last decade, some taxpayers ended up with mortgage loans modified in various fashions. Some of these taxpayers (especially those who had "name your payment" loans that didn't require paying any particular amount for a period of time) ended up with mortgages where interest had not been fully paid.

After Wall Street discovered that, yes, real estate can go down in value and their models did not insure that mortgage pools of loans with terms like "name your payment" couldn't lose value, borrowers discovered that new loans would not allow them to accrue that interest—so when they ended up with modified loans, the unpaid interest would be "rolled into" the balance of the loan.

The taxpayer in *Copeland v. Commissioner*, TC Memo 2014-226 was in such a situation. Their original loan had ended up in the hands of Bank of America, and the taxpayers arranged for a modification of the loan with Bank of America.

The modified loan made the following changes:

- The interest rate was reduced

- Payment terms were changed

- The loan balance was increased to include $44,678 of unpaid interest

Thus the mortgage balance increased on the new mortgage. That mortgage continued to be with Bank of America.

The taxpayers file their return (as do most individuals) on the cash basis of accounting. The 1098 they received from Bank of America for the year showed interest paid of $9,253. On their Schedule A, however, the taxpayers claimed a larger deduction ($48,078) based on having refinanced accrued interest.

However the taxpayer, as the Court points out, cannot do that. The taxpayer refinanced an outstanding loan with the same lender (Bank of America). As such, nothing really changed—they simply have promised to pay Bank of American what they had already promised to pay (the interest on the original loan) and, under their method of accounting, such a deduction only takes place when actually paid in cash to that lender.

Had the taxpayers obtained financing from another lender they would have been allowed an interest deduction—because, in this case, they would have paid their obligation to Bank of America and now owed a new loan to a different lender. The taxpayers asked the Tax Court to treat their situation "as if" they had done just that.

The Court noted that the problem was they did not do so. And, the Court notes, there's no reason to believe they could have found another lender to make that loan. If they could have done so and they wanted the interest deduction, they should have obtained that financing from a party other than the original lender.

Section: 163
Taxpayer's Payment of All Expenses Related to Residence Not Sufficient to Show She was Equitable Owner of the Property

Citation: Puentes v. Commissioner, TC Memo 2014-224, 10/27/14

In this case we take a look at the "responsible sister/daughter" who found that although she made payments on a mortgage for the home in which she lived with her father and brother after her brother lost his job, she was not allowed to claim the home mortgage interest deduction. In fact, this case *Puentes v. Commissioner*, TC Memo 2014-224, was the second year that Ms. Puentes had been before the Court on this issue. Her first case, again TC Memo 2013-277, was actually on appeal to the Ninth Circuit Court of Appeals as this case was heard.

Lourdes Puentes lived in South San Francisco in a home originally acquired by her brother, Benjamin. He made the down payment on the property in 2002 and acquired a mortgage on the property. He also was, and remained, the sole person recorded on the title for the property.

In 2003 Ms. Puentes moved in to the property and in 2005 their father joined the brother and sister in the home. In 2009 Benjamin lost his job and Lourdes began paying the mortgage. She also paid the property taxes and homeowners insurance on the property for the year in question.

The IRS, as you may expect, noticed that there was no Form 1098 issued to Lourdes when they attempted to match her deductions—the Form 1098 on the property was issued to her brother, the person obligated on the loan.

The fact that Lourdes was not listed as the owner per the recorded title is not necessarily conclusive. Treasury Reg. §1.163-1(b) provides that "interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness."

However, equitable ownership is determined by reference to local law—in this case that of the state of California. California law provides that the person listed as the owner on the title for a property is presumed to be its owner, a presumption that can only be overcome by “clear and convincing” evidence of a different ownership. For instance, an agreement between the parties evidencing a different ownership than on the title may suffice to overcome this presumption.

However, the Tax Court noted that California law (citing the case of *In re Marriage of Broderick,* 257 Cal. Rptr. 397, 400) is not satisfied in this regard merely by tracing the source of fund used to purchase the property.

Unfortunately the fact that Ms. Puentes had paid the expenses was the only sort of “proof” she able to offer in this case. She offered no evidence that her brother intended her to be granted an ownership interest in the home.

The Court notes:

> Petitioner has acted admirably to enable her family to retain its home at a time of economic difficulty, and we empathize with her position. As a matter of technical tax law, however, we are constrained to agree with respondent.

Section: 163
Equitable Ownership Not Demonstrated, Taxpayer Denied Deductions Related to Property Titled in Her Sister's Name

Citation: Luciano-Salas v. Commissioner, TC Summary Opinion 2014-76, 8/11/14

Taxpayer who have an equitable interest in a personal residence and who make the mortgage payments, even though not listed on the title or the mortgage itself, may still qualify to claim the mortgage interest deduction under IRC §163.

The problem, however, is that a taxpayer claiming equitable ownership has to do more than simply announce this fact—they must show the equitable ownership would be recognized under state law. In the case of *W*, http://ustaxcourt.gov/InOpHistoric/Luciano-SalasSummary.Guy.SUM.WPD.pdf, the taxpayer fell short of this standard for a number of reasons.

Dolorosa claimed that the property she lived in (a duplex) was purchased by her sister (whom she claimed lived with her husband in a bordering state) and titled in her sister’s name because of Dolorosa’s poor credit history. That argument is one that has been seen before in equitable ownership cases where the taxpayer had prevailed.

But Dolorosa faced some issues with her claim that successful taxpayers did not have. First, she only paid the mortgage payments sporadically. While she claimed to have paid various expenses related to the property, she offered no evidence of the same.

Most importantly, Dolorosa did not produce any written agreement between herself and her sister to show that she was the equitable owner, nor did she have her sister testify at trial.

In fact, her sister had claimed the property has her residence during her own Chapter 13 bankruptcy proceeding. Her sister was also awarded damages by the bankruptcy court when a lender attempted to foreclose the property while the bankruptcy proceeding was in effect. Obviously, if her sister wasn’t the true owner of the property there seems to be some issue with her sister’s filings with the bankruptcy court.

The Tax Court decided that Dolorosa failed to show that she was truly the equitable owner of the property.

What could have changed the result here? The best way to document equitable ownership is to have written confirmation of such an arrangement. It's also important that the parties (both the taxpayer's and that of the person listed on the title) be consistent with the taxpayer being the "real" owner of the property.

Section: 163
Failure to Record Mortgage on Loan From Relative Fatal to Home Mortgage Interest Deduction

Citation: DeFrancis & Gross v. Commissioner, TC Summary Opinion 2013-88, 11/6/13

A failure to take care of details ended up with a taxpayer being denied a deduction for home mortgage interest deduction on a loan from a relative in the case of DeFrancis & Gross v. Commissioner, TC Summary Opinion 2013-88, http://www.ustaxcourt.gov/InOpHistoric/DeFrancisSummaryPanuthos.SUM.WPD.pdf.

The taxpayers had borrowed money from the wife's mother and signed a loan document that was described as a "mortgage note" and another document which provided that they "hereby mortgage grant, convey and assign to * * * [Joan Gross] the property with an address of 41 Maynard Road." Five years later they obtained a loan from TD Bank for $200,000, pledging the same property as security. They did not disclose the existence of the relative's mortgage when they applied for that loan.

The taxpayers claimed an interest deduction of $20,368 for 2009, of which $19,320 came from the relative's loan. The IRS disallowed the deduction on exam, noting that interest claimed was in excess of the Form 1098.

To be considered acquisition home mortgage debt, the debt must be secured by the residence in question. Temporary Reg. §1.163-10T(o)(1) provides that a secured debt is:

> a debt that is on the security of any instrument (such as a mortgage, deed of trust, or land contract)—
>
> > (i) That makes the interest of the debtor in the qualified residence specific security of the payment of the debt,
> >
> > (ii) Under which, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated, and
> >
> > (iii) That is recorded, where permitted, or is otherwise perfected in accordance with applicable State law.

The debt met the first requirement by its terms, providing the residence was security for the property.

However, they had not recorded the debt with the County. In the state in question, an unrecorded mortgage is not valid against parties who do not have notice of the mortgage. In that case, the mortgage would not sufficient to satisfy the debt in the same priority as a recorded mortgage, failing the second test.

Similarly, the debt failed the third test as the Court was not convinced that the debt was perfected under state law. The fact it was valid as a secured debt between the taxpayers and the relative was not sufficient to meet the third prong.

Thus, the taxpayers were not allowed to claim a deduction for the $19,000+ in interest paid to the relative.

Section: 165
Lack of Records Leads to Denial of Gambling Losses for Taxpayer, Penalties Imposed

Citation: Burrell v. Commissioner, TC Memo 2014-217, 10/14/14

A taxpayer who has gambling winnings is allowed a deduction for losses up to the amount of the winnings. But that deduction still requires the taxpayer to maintain documentation, a fact that the taxpayer in *Burrell v. Commissioner*, TC Memo 2014-217 discovered when she attempted to claim losses to offset three years worth of gambling winnings.

Ms. Burrell apparently spent significant time pursuing gambling activities—her reported winnings for the three years were $338,100, $296,772 and $226,563 which happened to be the results the casinos reported to the IRS. Each year she reported losses equal to those winnings. She primarily played slot machines and gambled in cash.

On examination the IRS demanded some documentation for the claimed losses. What the taxpayer provided were:

- Documents for two of the years that listed the dates Ms. Burrell gambled, the names of the casinos and the daily amount of cash she brought to the casino each day
- Letters from various casinos she visited that estimated her gambling activities at each casino
- ATM receipts and cash advance receipts from the casinos she frequented.

The IRS (and the Tax Court) ignored the first item in the above list. While Ms. Burrell documented how much cash she brought to the casino, there was no record of what she did with those funds or how much cash, if any, remained in her possession at the end of the day. That last factor is a key difference from the "per session" accounting that was allowed in the case of *Sang J. Park and Won Kyung O v. Commissioner*, 2013-2 U.S.T.C. ¶50,423, CA DC, reversing 136 T.C. 569, where the taxpayer did have a record of "end of day" balances.

The agent used the casino letters, along with the ATM and cash advance receipts, to determine the losses to allow. In two of the three years the allowed losses were significantly less than the taxpayer claimed (about 70% of the amount of total winnings over the three years, rather than 100% of such winnings).

The Tax Court notes that taxpayers are required to maintain adequate records to establish their tax liability per Reg. §1.6001-1(a). While the *Cohen* doctrine (from *Cohan v. Commissioner*, 39 F.2d 540, CA2, 1930) does allow the Tax Court to estimate expenses on most (though not all) expenses, the Court can only do so if the taxpayer presents sufficient evidence to allow for a reasonable estimate, with that estimate having to be computed "bearing heavily" against the taxpayer when that taxpayer is the reason why inadequate records exist.

The Court found that the taxpayer had not presented sufficient evidence to justify any amounts in excess of what the IRS found on exam.

The Court also found the taxpayer liable for the 20% accuracy related penalty under §6662. Since the tax assessed was in excess of the amount necessary for a substantial understatement of tax (the greater of 10% of the tax required to be shown or $5,000) the taxpayer could only escape the penalty if she showed her position had substantial authority or she could show reasonable cause and good faith for the position that lead to the understatement..

Substantial authority is a concept of tax law, not an issue generally related to facts. In this case the taxpayer failed to keep adequate records of losses to justify what she claimed. In this case she would have needed to show substantial authority for keeping inadequate records—not a very winnable proposition and not one she claimed.

However she did claim reasonable cause and good faith based on reliance on the counsel of a tax professional. However to do that the taxpayer must show:

- The advisers was a competent professional with sufficient expertise to justify reliance;
- The taxpayer provided all necessary and relevant information to the preparer; and
- The taxpayer actually relied in good faith on the adviser's judgment

In this case the taxpayer did not have her preparer testify at trial, nor did Ms. Burrell present evidence of the preparer's expertise or what information she gave to this person. Thus the Court found she failed to show she acted with reasonable cause and in good faith. Thus the penalty was sustained.

Section: 165
Individual Not in Trade or Business of Loaning Money, Thus Could Not Qualify for Business Bad Debt Deduction

Citation: Langert v. Commissioner, TC Memo 2014-210, 10/8/14

The question of what is actually a business bad debt was the key issue in the case of *Langert v. Commissioner*, TC Memo 2014-210. Mr. Langert claimed he loaned a couple $157,045 which he claimed became a worthless business bad debt in 2009.

Mr. Langert had loaned the individual the funds to acquire a piece of property. He did have the couple sign a note to him. However he did not require the property to be pledged as security for the loan, he did not check the credit ratings of either party nor did he ask to see financial statements or other financial information for those individuals. He also failed to verify the source of funds from which the debtors would be able to meet their obligation under the note.

When the couple defaulted Mr. Langert was also someone nonchalant about the affair. While he asked the husband to repay the loan orally, he never asked for repayment in writing and never approached the wife at all with regard to the obligation. When the couple filed bankruptcy, Mr. Langert also failed to file a proof of claim in the case.

Mr Langert claimed an ordinary deduction for the unpaid balance of the debt as a business bad debt in 2009.

The IRS objected on a number of fronts. These included the IRS claim that:

- Mr. Langert failed to show that this was a bona fide debt
- He also failed to show that even if it was a bona fide debt that it became worthless in 2009 *and*
- Even if both of those points are conceded, he failed to show that the item in question was a business bad debt

The impact of the IRS positions are effectively summarized as:

- If the debt is truly not a bona fide debt (or, at least, Mr. Langert is unable to show it was one) then no deduction would ever be allowed.

- If there is a debt, a deduction could only be claimed in 2009 if Mr. Langert can show the debt became worthless in 2009, which would require showing it was worthless by the end of 2009 and it was not worthless at the end of 2008. If it was worthless prior to 2009, Mr. Langert would be claiming the deduction in the wrong year. And if it had not become worthless by end of 2009 any deduction would have to be taken in a later year.
- If a bad debt is not a business bad debt, then the loss would be a capital loss—and therefore subject to rather strict limitation on deduction for such losses (limited to no more than $3,000 in excess of any net capital gain from other transactions).

The Tax Court decided to simply accept for the sake of argument that the debt was bona fide. As you might guess, this willingness of the Court to accept the bona fide nature of the debt was a sign the Court likely found the deduction was going to blocked by other factors.

The Court first looks to whether, in fact, this debt would be a business bad debt and concludes that answer is no. The Tax Court notes that to establish a business bad debt the taxpayer must show either:

- The debt was created or acquired with regard to the taxpayer's trade or business *or*
- The debt is one for which the loss or worthlessness is incurred in the taxpayer's trade or business

Mr. Langert claimed it met the tests because he entered into the loan "for the sole purpose of obtaining interest income." The Court found that was not, by itself, sufficient for a finding of a trade or business—after all, individuals depositing funds with a bank in certificate of deposit are doing so most often "for the sole purpose of obtaining interest" but that doesn't mean everyone with a CD is operating a trade or business.

A key problem is that Mr. Langert has to show he was involved in an activity of making loans that was, per a citation from the case of *Imel v. Commissioner*, 61 TC 318, 323 (1973), "so extensive as to elevate that activity to the status of a separate business." Mr. Langert testified that he had made 6 loans over 30 years—hardly an "extensive" loan making operation. The court notes that *Imel* had made 8 or 9 loans over a 4-year period and that was held to not be extensive enough—and Mr. Langert fell far short of even that minimal level of activity.

The Tax Court dismisses the remaining question (did the loan, if it was a loan, become worthless in 2009) by noting Mr. Langert had failed to show an *identifiable event* occurring in 2009 that would have provided reasonable grounds for abandoning hope for collection of the debt in that year.

Section: 165
Taxpayer Failed to Show Worthlessness of Investment or Deductible Theft in Year Claimed

Citation: Bunch v. Commissioner, TC Memo 2014-177, 8/28/14

In the case of *Bunch v. Commissioner,* TC Memo 2014-177, there was no question that the taxpayers had entered into a transaction with a major loss—in 2000 they had put $4,044,096 into an investment that promised to pay a 20% rate of interest on mortgages.

In 2001 several of the loans went into default, but the taxpayers were not made aware of this fact. Rather they continued to receive regular interest payments on their investments until March 31, 2006. On April 13, 2006 the investment organization filed bankruptcy, claiming to have assets of $50-$100 million and liabilities (including those due to Mr. and Mrs. Bunch). Eventually (in 2009) the promoter would plead guilty to wire fraud.

The Bunchs claimed on their original return for 2006 that they had a bad debt deduction of $4,044,096. Upon the promoter's guilty plea in 2009 they amended the return to claim the amount as truly a theft loss.

However, the Tax Court found problems with both claims—mainly in the area of the timing of deductions.

The Court noted that, as the Bunches were investors, the debt was a nonbusiness debt. That is important since, as the Court points out, while deductions are allowed for partial worthlessness for a business bad debt, a deduction for a nonbusiness debt is allowed only if the debt is worthless.

The Court found the taxpayers did not show worthlessness as of 2006. First, the Court noted that a number of the facts of the case were not known until after the end of 2006. As well, the taxpayers filed a claim in the Bankruptcy Court. The taxpayers claimed they did so only to establish the amount of their loss, but the Court noted that the filing had the effect of protecting their interest and, eventually, lead to a partial repayment with a distribution in 2009.

So while there was little doubt the debt was worth far less than its face amount by the end of 2006, it could not be shown to be worthless.

A similar problem arose with the theft theory. First, a taxpayer has to show the actions of the other party rose to the level of theft based on information known during the year in question. The Court found that the taxpayers failed to make that showing.

But even more to the point, the taxpayer also has to show that there is no prospect of a recovery—and, again, that was not shown as of the end of 2006.

So while there's little doubt the taxpayers were economically worse off by the end of 2006 due to having made this investment, the events allowing recognition of that loss for tax purposes had not taken place by the end of 2006.

Section: 165
Casualty Loss Not Automatically to Be Denied on Public Policy Grounds When Built in Knowing Violation of Local Laws

Citation: Chief Counsel Advice CCA 201346009, 11/22/13

The taxpayers whose issue is discussed in Chief Counsel Advice CCA 201346009, http://www.irs.gov/pub/irs-wd/1346009.pdf, wanted to live "without Government interference" and thus built his home without obtaining required state and local permits. He also acquired another structure built with similar disregard for state and local building laws.

It appears that there are limits to avoiding government involvement that this taxpayer saw, for when his properties were destroyed in a fire he claimed a casualty loss on his tax return. The agent examining the return believed that the casualty loss should be denied on public policy grounds, as the taxpayer had knowingly and blatantly violated the requirements.

The Chief Counsel's office did not agree. The memorandum notes that there are times when the courts have denied otherwise allowable deductions because they would frustrate public policy. For instance, in Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 35 (1958) the Supreme Court denied a deduction for fines imposed for driving overweight trucks.

The memo indicates that a key factor has been whether the taxpayer's proscribed conduct leads to the loss being claimed. For example, the memo cites the case of Blackman v. Commissioner, 88 T.C. 677 (1987) a taxpayer was denied a casualty loss for his home that was consumed by a fire that began when he set his wife's clothes on fire. But the memo contrasts this case with that of Hossbach v. Commissioner, T.C. Memo. 1981-291 where a loss was allowed for a fire resulting from the taxpayer illegal drug making activities, holding that he did not recklessly create a risk of catastrophe in violation of state statute.

Similarly, if a taxpayer's conduct is directly related to the illegal activity a loss will be disallowed—such as person who provided real currency to be used to create counterfeit currency who found his "partners" decided to take the real stuff with them (Mazzei v. Commissioner, 61 T.C. 497 (1974)).

The memo goes on to note that courts disallowed deductions for fines and penalties because they would serve to reduce the intent of the statutes that such fines and penalties are meant to discourage the conduct by effectively providing a subsidy reducing the impact of the fine or penalty.

The memo finds that the taxpayers' conduct is not of a nature that meets the requirements for disallowance. The memo concludes:

> We believe that allowing the casualty loss would neither severely frustrate nor defeat the purpose of the State laws requiring permits or lessen the sting of the various punitive measures prescribed by State and County law for failure to obtain proper permits. Additionally, allowing the casualty loss deduction would not necessarily increase the odds in favor of non-compliance and encourage others to build without obtaining the proper permits. State has specific punitive measures for property owners who do not obtain the required permits (e.g. placing a notice of violation on the property, imposing penalties and fines). Allowing Taxpayers' casualty loss deduction here would have no impact on these punitive measures.

The memo does not, though, that the taxpayers may have another problem—in the facts, it's noted the taxpayers haven't really substantiated the basis. So while they may "win" on the law issue, it seems very possible that they may still find no real benefit allowed.

Section: 165
IRS Describes How to Report Phantom Income from Ponzi Scheme When Rev Proc 2009-20 Not Elected or Not Available

Citation: PMTA 2013-003, 10/25/13

In Program Manager Technical Advice (PMTA 2013-003), the IRS outlines how a taxpayer who either does not qualify to make use of the safe harbor for reporting "Ponzi" scheme activities under Revenue Procedure 2009-20 or does not elect to use the safe harbor may deal with the scheme.

The PMTA deals with a case where a taxpayer was found to have invested in a fraudulent Ponzi scheme, though he/she was not aware of it at the time. The taxpayer had reported income from the scheme over the years, though the "income" was illusory. Investors that requested payment of their income in cash rather than being reinvested would be paid, at least partially, from funds received from new investors. Similarly, when an investor requested a withdraw the funds would come from the same source, rather than from an account actually being held for the taxpayer.

The PMTA is presented in a question and answer form.

The PMTA first deals with what the taxpayer may do for any open years:

> Q. 1: May a taxpayer amend returns for years in which the period of limitations for filing a claim for refund has not expired ("open years") to eliminate from income amounts that were falsely reported to the taxpayer as income ("phantom income")?

A. 1: Yes. A taxpayer who does not or cannot use the safe harbor procedure provided in Rev. Proc. 2009-20 has two options:

a. The taxpayer may deduct the investment in the scheme, including amounts previously included in income, less cash withdrawals from the investment, as a theft loss under I.R.C. §165(c)(2) in the year the theft is discovered (or later, if there is a reasonable prospect of recovery). For this purpose, it is irrelevant whether the prior income was fictitious or genuine.[1]

b. Alternatively, the taxpayer may amend returns for open years to recalculate income for those years by removing phantom income. If the taxpayer withdrew in cash amounts that were previously reported as income in an open year, the taxpayer would treat the withdrawal as a nontaxable return of capital. See Answer 2 below. If the taxpayer did not withdraw those amounts and reported the income as being constructively received, then the taxpayer would treat the phantom income as never having been received. The taxpayer must establish the amount of income that was fictitious in the open years.

The IRS next moves on to discuss how to deal with withdrawals the taxpayer has taken out, and how to deal with "closed" years where the taxpayer does not have the option of recovering tax paid on phantom income.

Q. 2: When amending prior tax returns to eliminate phantom income, how does a taxpayer treat cash withdrawals from the investment scheme in open years? How does a taxpayer treat amounts that were included in income in years in which the period of limitations for filing a claim for refund has expired ("closed years")?

A. 2: If the taxpayer chooses to amend prior returns to eliminate phantom income and establishes the amount of income that was fictitious, then withdrawals of the taxpayer's investment, or "basis", in the scheme in an open year may be treated as a nontaxable return of capital. For this purpose, the "basis" in the scheme is the sum of the following: prior cash investments, plus amounts previously reported as income, less prior cash withdrawals.[2] The basis consists of all amounts included in income in closed years, without regard to whether that income was fictitious or genuine.

[Note 2] In this memorandum, we will use the terms "basis" or "unrecovered investment" to denote the investment in a scheme that has not yet been recovered for tax purposes.

A taxpayer whose withdrawals exceed his/her basis is covered in question 3:

Q. 3: What is the treatment of withdrawals in excess of the taxpayer's investment in the scheme?

A. 3: If and to the extent that a taxpayer withdrew amounts in excess of the basis in the scheme, the taxpayer must include those amounts in income in the taxable year in which they are received. The calculation of basis is discussed in Answer 2 above.

The memo goes on to note that a "reasonable prospect of recovery" does not delay relief from treating the phantom income as not income, unlike the situation where a taxpayer attempts to claim a §165 theft loss:

Q. 4: Does a reasonable prospect of recovering the taxpayer's investment in a bankruptcy or similar proceeding prevent the taxpayer from amending prior returns to eliminate phantom income?

A. 4: No. A reasonable prospect of recovering a taxpayer's investment postpones a theft loss deduction under section 165, but does not postpone or prevent amending prior returns to eliminate phantom income under section 61.

Finally, the advice addresses how to deal with the "leftover" basis, noting the taxpayer retains the ability to eventually claim a theft loss. However, remember that, in this case, the taxpayer is working under the "normal" theft loss rules since he/she did not elect, or was not eligible to elect, the special treatment under Rev. Proc. 2009-20:

> Q. 5: May a taxpayer who files amended returns to eliminate phantom income in open years still have a theft loss deduction? If so, how is it calculated?
>
> A. 5: Yes. To the extent that a taxpayer who amends prior returns to eliminate phantom income in open years does not recover the entire basis in the scheme as a return of capital under section 61, the remaining basis is deductible as a theft loss under section 165, in the year the theft is discovered (or later, if there is a reasonable prospect of recovery).

There is one more question presented, but the answer is redacted in the published version of the PMTA. The "secret" answer is in relation to the following question:

> Q. 6: Should the Service assert that the taxpayer cannot eliminate phantom income in open years because in each year the taxpayer constructively received not only an amount equal to the purported income but also the taxpayer's entire investment?

Later in the PMTA the IRS discusses the issue and provides the following discussion:

> Questions have arisen as to whether the Service may assert the doctrine of constructive receipt to claim that a taxpayer has income from a fraudulent investment scheme -- even if the taxpayer chooses to eliminate phantom income from open years -- on the theory that the taxpayer could have withdrawn the taxpayer's entire investment in the scheme.
>
> For example, assume a taxpayer invested $100 and the scheme reported $10 of income to the taxpayer, which the taxpayer chose to withdraw in cash. The taxpayer can show that the purported payment of income was not actually income, and seeks to recharacterize it as a nontaxable return of a portion of the $100 investment. The question arises whether the Service may assert that the taxpayer should be treated for tax purposes as having constructively withdrawn the full $110 in the account (and reinvested $100), with the result that the taxpayer would be viewed as having withdrawn more cash that the taxpayer invested. This treatment would result in $10 of income and the taxpayer would not be able to eliminate any phantom income on the amended return, even if the $10 that was reported as income was fraudulent.8
>
> Income is constructively received if it is made available so that the taxpayer may draw upon it at any time, but not if control of its receipt is subject to substantial limitations or restrictions. See section 1.451-2(a) of the Income Tax Regulations. In specific circumstances, courts have applied the doctrine of constructive receipt to investors in Ponzi schemes. See Premji v. Commissioner, T.C. Memo. 1996-304, aff'd without published opinion, 139 F.3d 912 (10th Cir. 1998) (taxpayer failed to report certain interest income; court held that taxpayer must report the income earned on the principal amount that taxpayer chose to reinvest); Marretta v. Commissioner, T.C. Memo. 2004128, aff'd without published opinion, 168 Fed. Appx. 528 (3d Cir. 2006) (unreported income from Ponzi scheme; taxpayer failed to prove that amounts were return of capital; taxpayer stipulated that principal was available to him on request). However, whether receipt is subject to substantial limitations or restrictions, including the payor's practical ability to pay, depends on the facts and circumstances. See, e.g., Johnson v. Commissioner, 25 T.C. 499, 503 (1955), acq., 1956-2 C.B. 6; Rosenberg v. United States, 295 F. Supp. 820, 822 (E.D. Mo. 1969), aff'd, 422 F.2d 341 (8th Cir. 1970).

> Under this case law and given the factual nature of the issue, the Service has some discretion to determine when to assert the doctrine of constructive receipt in the recomputation of Ponzi income.

At this point, there is more redacted text, presumably outlining just what the IRS should consider in exercising that "discretion" in such a case.

While we don't know what is in there, it is probably safe to assume that the IRS is likely going to apply some sort of "smell" test in these cases, so if it seems the taxpayer is "gaming" the system, the IRS may assert this position. Since a taxpayer that is eligible to elect and does elect the Rev Proc 2009-20 treatment knows the position is acceptable, this reservation may serve as a "suggestion" that a taxpayer should use that procedure if possible and that if the IRS believes a taxpayer elected out to obtain an "unfair" advantage they might assert the constructive receipt theory.

Section: 170
Bulk Donations Valuations for Charitable Contributions Purposes Can Take Into Account Discounts That Would Be Applied to Such a Builk Sale

Citation: CCA 201443039, 10/24/14

In Chief Counsel Email 201443019, the National Office commented on how to handle claims for deductions of large number of assets at the same time. In the situations discussed the taxpayers had bought items in bulk (and at a substantial discount), held them for over a year and then attempted to claim a deduction for the fair value of each individual item.

The email notes that while the IRS had attempted in the past to deny any deduction for such items for values of such items in excess of the original purchase price by arguing the taxpayers were dealers (see Rev. Rul. 79-256 and Rev. Rul. 79-419), the Tax Court had not generally agreed with that view.

However the email points out that the Tax Court had agreed that the true value of such a bulk donation had to be determined using the value of the items taken as a group (and thus with the very discounts that the taxpayers had obtained in purchasing the items to begin with). In the case of *Skripak v. Commissioner*, 84 T.C. 285, the email notes that the Tax Court, in looking at a bulk donation of books, had determined that an attempt to dispose of all of the books at one time would have depressed the market for such items, and thus any determination of fair value needed to take that effect into account when the entire set of items were donated during the year in question.

Section: 170
"Disregarded" LLC Must Be Considered When Valuing Charitable Contribution

Citation: RERI Holdings v. Commissioner, 143 TC No. 3, 8/11/14

How and when a "disregarded" entity is not disregarded can be a tricky issue for tax purposes. Reg. §301.7701-2(c)(2)(i) provides that, generally, an LLC with only a single member is treated as an entity to be disregarded from its owner for federal tax purposes. Since §7701 provides for definitions that apply throughout the entire Internal Revenue Code, it might seem that this "disregarded" rule would apply for any tax issue.

But it's not quite that simple. In the 2009 case of *Pierre v. Commissioner*, 113 TC 24 the Tax Court held that, for purposes of determining a valuation for estate and gift tax purposes, the existence of a single member LLC, even though treated as a disregarded entity by the taxpayer prior to the gift, would not be ignored when determining the value of the interest transferred.

A slightly different question confronted the court in the case of *RERI Holdings v. Commissioner*, 143 TC No. 3, (http://ustaxcourt.gov/InOpHistoric/RERIHoldingsI,LLCDiv.Halpern.TC.WPD.pdf). In this case the issue involved valuation of a remainder interest in an asset for purposes of a charitable contribution deduction under IRC §170.

This particular case involved an IRS motion for summary judgment on issues in the case, a motion that was denied as the Court found there were still issues of fact to be decided.

The item contributed was real property held in an LLC 100% of the interests of which were held by the taxpayer. Quite often real is placed into an LLC "wrapper" to help insulate owners from potential liabilities related to the property.

The taxpayer had granted a remainder interest in the property to a charity and obtained an appraisal of the real property and then used the tables provided for by §7520 to value the remainder interest.

The IRS protested that the wrong asset had been valued—the charity was given the interest in the LLC rather than in the real estate, and thus the interest in the LLC should have been valued. The IRS also argued that the transferred interest was not of a type for which the discount tables found in §7520 can be used.

The Court agreed with the IRS that, in fact, the LLC had to be respected for valuation purposes despite being "disregarded" for federal income tax purposes generally under Reg. §301.7701-2. The Court noted:

> We were faced in Pierre, as we are faced here, with identifying the appropriate property against which to apply the customary willing seller and willing buyer standard (here, as a first step in applying the section 7520 tables). The customary willing seller and willing buyer standard is described in substantially identical language both for valuing charitable contributions of property for income tax purposes and for valuing gifts of property for gift tax purposes. Compare sec. 1.170A-1(c)(2), Income Tax Regs., with sec. 25.2512-1, Gift Tax Regs. See sec. 20.2031-1(b), Estate Tax Regs. (same definition for estate tax valuations). And it is only on account of a charitable contribution deduction provided for in the gift tax statute that gifts to charity are not included in the amount of taxable gifts. See sec. 2522. We see no reason to identify the property to be valued for income tax purposes (and subject to a charitable contribution deduction) differently from the property to be valued for gift tax purposes (and subject to a charitable deduction).

The Court did agree with the taxpayer that it is *possible* there would be no material in value between the value of the LLC and the underlying real estate. If so, the Court indicated that it would be willing to apply a "no harm, no foul" test on the appraisal—but the Court noted that, due to certain provisions in the various documents, the issue of whether this was a "no harm, no foul" situation was not appropriate to be decided in this proceeding.

Similarly, while the Court agreed with the IRS that it is possible that various issues related to this transaction might make the use of the §7520 tables inappropriate, the Court also found that these were issues to be decided in later proceedings.

The key take-away from this case is that advisers need to make sure that qualified appraisals of donations of property held in a SMLLC take note of the existence of the LLC and appraise that asset as the asset donated. While the court left open the door to argue a "no harm, no foul" approach, prudence suggests that it would be best to avoid having to make that argument—remember that the taxpayer in this case still has to go to court and *prove* that the value of the LLC and the underlying real estate are truly the same or the taxpayer will lose the deduction due to not having a qualified appraisal to back up the deduction.

Section: 170
Second Circuit Reverses Tax Court Holding that an Appraisal Using a Percentage Discount Valuation Method for Conservation Easement Not a Qualified Appraisal

Citation: Scheidelman v. Commissioner, TC Memo 2013-18, 1/16/13, affirmed CA2, 6/18/14

The issue in the case of *Scheidelman v. Commissioner*, 2012 USTC ¶50,402, vacating and remanding TC Memo 2010-151, was the taxpayer's appraisal report in support of a charitable deduction. The Tax Court found the appraisal failed to meet the standards for a qualified appraisal, and ruled the taxpayer lost the entire charitable deduction claimed for a conservation easement. However, the Second Circuit Court of Appeals disagreed that the use of a percentage discount "method" had violated the "qualified appraisal" requirement, and that the Tax Court will need to rule on other issues to decide the case.

IRC §170 allows for a charitable deduction for, among other things, the contribution of a qualified conservation easement on a property to a charity. However the deduction is limited to the value of the easement and if that value claimed is in excess of $5,000 (which would normally be the case) then a taxpayer is required to obtain a qualified appraisal of the property, attaching a fully completed Form 8283 and maintain the required records to support the contribution.

In this case the taxpayer made such a contribution of an easement on a property she owned in Brooklyn, NY. She engaged the services of an appraiser chosen from a list of appraisers suggested to her by the charity to which she would make the contribution. The appraiser's report did contain an appraisal of the property without an easement attached, but was short on details on the value of the property once an easement was in place.

The Tax Court concluded that, effectively, the stated justification in the appraisal was that the IRS and Tax Court had generally allowed easements equal to 10-15% of the value of the property, which is in line with what the case law cited held. But the Tax Court opinion argued that using prior percentages from court cases was not a valid method of appraising property, and that without some more justification for the exact amount of the appraised value with an easement in place. As Reg. § 1.170A-13(c)(3)(ii)(J) requires that a qualified appraisal contain a description of the method used to value the property, the Court found that this flaw meant no qualified appraisal had been undertaken or attached to the return. As such the Tax Court decided no deduction was allowed.

The Tax Court also complained that the Form 8283 was not properly completed on the return either. The Form 8283 had omitted the date and method of acquisition of the property contributed, as well as the taxpayer's basis. While this defect does not appear by itself to have doomed the taxpayer's deduction, it did mean the taxpayer now had to show substantial compliance with the regulations, and the Court held that a lack of a qualified appraisal was effectively fatal to any attempt to argue substantial compliance.

On a more minor issue, the taxpayer also was denied a deduction for an amount of cash she was required to pay the charity as part of the transaction. The organization required contributors of easements to make a cash contribution equal to a percentage of the value of the easement for it to be accepted. While the entity was a recognized §501(c)(3) organization, the Court held the taxpayer failed to show she had not received a benefit equal in value to the amount paid and, as such, no deduction was allowed for that amount either.

The Second Circuit rejected each of these holdings. First, the Court found that while there may very well be a question about the reliability of the method used by the appraiser, the Court found that the appraiser had clearly apprised the IRS of the method that had been used to arrive at his appraisal figure. The Court noted the Tax Court had approved virtually the same method in its decision in the case of *Simmons v. Commissioner*, TC Memo 2009-208.

The appellate panel also found the Tax Court in error in finding the Form 8283 deficient. While the signed copy of the Form 8283 did have the deficiencies mentioned, a second Form 8283 attached to the return contained the "missing" information. At best the Court found any deficiency to be a minor technicality, and thus the taxpayers had substantially complied with the regulatory requirement.

Finally, the Second Circuit did not agree that the cash payment was an impermissible quid pro quo arrangement. While the cash payment might have been a prerequisite for the contribution, the Court held that no "goods or services" or other "benefit" was provided to the taxpayers in exchange for the donation. The fact they would be able to obtain a tax deduction was not found to the Court to represent such a benefit.

It is important to note the Second Circuit did not grant the taxpayer a victory—it merely allowed the argument to continue on the amount, if any, of deduction to which the taxpayer was entitled to for the conservation easement. But it does at least allow the taxpayer to make a case for the existence of a contribution.

Unfortunately, for the taxpayer, the Tax Court found, not unexpectedly, that this valuation wasn't persuasive of any allowed value. On remand, the Tax Court found that no deduction would be allowed (TC Memo. 2013-18). And, in a follow-up, the Second Circuit affirmed the Tax Court's second revised decision in the case. (Docket No. 13-2650, 2014 TNT 118-15)

Section: 183
Despite Decades of Losses, Taxpayer Found to Have Profit Motive for Business as Artist

Citation: Crile v. Commissioner, TC Memo 2014-202, 10/2/14

In the case of *Crile v. Commissioner*, TC Memo 2014-202 a taxpayer who held a teaching position at a college was challenged by the IRS for deduction related to her business as an artist.

On paper the numbers looked bad for this taxpayer. For the years in question the taxpayer reported gross receipts of no more than $6,525 in any of the years involved (2004-2009)—in fact, she had no receipts whatsoever in 2008 from the art activity. Her claimed losses ranged from $37,076 to $63,271 during the years in question, with most years being much closer to the high rather than low end of that range. The taxpayer had been a professional artist from 1971 to 2013, but had only shown a profit in one prior year and, possibly, for 2013 (her 2013 return was apparently not available at the time of trial). Many advisers would suspect such a taxpayer's case was "dead on arrival" when the IRS showed up.

But that would not prove to be the case here. While the financial results of her artistic business had proven disappointing, the Court did not find that she lacked the requisite profit motive. As the Court reminds us, the results of operations, while important, are not the sole arbiter of whether the hobby loss rules of §183 will apply to block loss deductions.

The IRS actually objected both on the basis that her operation was a "hobby" (with §183 applying) and, alternatively, that she had claimed deductions that were not justified under §162. This case only dealt with the hobby loss issue, with the Court delaying trial on the expense issue until later. But the Court did comment that many of her claimed expenses clearly were personal expenses which would be disallowed under §262(a)—thus, her economic losses were far less than actually claimed.

Under Reg. §1.183-2(b) the following factors are to be considered in determining if the taxpayer had a true profit motive in operating the activity:

- The manner in which the taxpayer conducts the activity;
- The expertise of the taxpayer or her advisers;
- The time and effort spent by the tax-payer in carrying on the activity;
- The expectation that assets used in the activity may appreciate in value;
- The success of the taxpayer in carrying on other similar or dissimilar activities;
- The taxpayer's history of income or losses with respect to the activity;
- The amount of occasional profits, if any;
- The financial status of the taxpayer; and
- Elements of personal pleasure or recreation

For the first criteria, the Court noted that it has not previously required a particularly rigorous standard for recordkeeping for artists. It found that Ms. Crile's records were similar to that the Court had found adequate for an artist in the case of *Churchman v. Commissioner*, 68 T.C. 696 (1977). The Court also found that taxpayer engaged in significant marketing activities related to her business, thus finding the first factor favored the taxpayer in finding a true profit motive.

The second point was effectively conceded by the IRS. The taxpayer was an artist that had sold art to various organizations, including the U.S. government, for public display in various locations, as well as in various galleries. She had many years of artistic experience. This factor again favored the finding of a profit motive.

The taxpayer worked 30 hours per week on her art activity when classes were in session and full time otherwise. The Court also found that her job as an art professor, far from detracting from her career as an artist, was rather synergistic with it. This also argues in favor of the taxpayer.

The IRS contended that, at this point, there was no reasonable prospect that appreciation in her art could overcome the long history of losses from the activity. However the Tax Court decided that wasn't the issue—rather, the true issue is whether the taxpayer could reasonably expect the value of her inventory to increase and noted that the value of artists' inventory increase dramatically late in their careers. The Court found this factor favored the taxpayer, though not as strongly as the first three.

The Court noted that for the fifth factor, this case had a reversed fact pattern compared to most hobby loss cases. Normally a taxpayer has a successful career and then embarks on the activity that leads to the hobby loss challenge. In this case the taxpayer was an artist for 25 years before obtaining her faculty position. The Court found the factor to have little relevance in this case, but since the taxpayer could reasonably have viewed her success in her faculty position could have led to an increased chance of success as an artist.

The history of losses is, in the Court's view, less significant for artists as they have a significant challenge—but a mere failure to be profitable does not show that there is not a profit motive. Also, somewhat interestingly, the Court reasoned that, based on what it has seen from the years before it, she quite likely claimed personal expenses in prior years. Thus, the Court reasoned, her real losses were likely far smaller than claimed and, perhaps, there were multiple years of economic profit.

The taxpayer argued that the financial crisis in the last half of the first decade of the 2000s depressed art prices. The Court agreed this impacted her results in those years, but note that this does not explain her long history of losses in earlier years. Overall the Court concluded this test favors the IRS, but then notes "no one factor is determinative"—or, to put it simply, the Court is telegraphing it is going to rule in the taxpayer's favor.

The Court found that being an artist is a speculative venture, and that it is possible to be wildly successful after years of losses. Thus the fact that she had only been profitable once in the past and was possibly on the way to her second year for 2013 was evidence she might be able to "break through" the factor weighs in her favor, though the Court notes not by much.

The Court did not find that her financial status was such that she was using the losses from the art activity primarily to shelter her income. The Court noted she had been an artist for years before becoming a professor, thus this factor was deemed neutral.

The Court also found that the taxpayer, in her artistic venture, had undertaken a number of not terribly enjoyable research activities in support of her artistic venture, including at one point for a series in a "Fires of War" series visiting Kuwait and accompanying firefighters to burning oil fields. She also spent many hours on mundane activities related to her art business rather than creating the art. The Court found this factor to be neutral or slightly favoring the taxpayer.

Since the Court found that only the history of losses favored the IRS, it concluded the taxpayer had shown she had an appropriate profit motive and thus did not agree with the IRS that §183 denied her a deduction for losses.

Section: 183
Earlier Finding of Profit Motive Did Not Protect Taxpayer From Later IRS Challenge

Citation: Chow v. Commissioner, TC Memo 2014-49, 3/24/14

In the case of Chow v. Commissioner, TC Memo 2014-49, http://www.ustaxcourt.gov/InOpHistoric/ChowMemo.Chiechi.TCM.WPD.pdf, a taxpayer found that merely having prevailed in a prior case does not necessarily mean the taxpayer will prevail in the future--even when the case involves exaclty the same issue and very similar facts.

The case involved the question of whether Mrs. Chow's gambling activities were a not for profit activity, with deductions limited by IRC §183. In the first Chow case, TC Memo 2010-48 (http://www.ustaxcourt.gov/InOpHistoric/Chow.TCM.WPD.pdf) the Tax Court found that, despite Mrs. Chow's losses in 2004 and 2005 from her gambling activities, she nevertheless had a profit motive in conducting the business--though the Court made clear it was a close call.

As it turns out, Mrs. Chow's gambling activities continued to show large losses for the next three years, the years now before the Tax Court. The Court notes that there is a significant change in facts this time:

> The facts established here differ materially from the facts in Chow I in that in the instant case we know that Ms. Chow continued to have substantial gambling losses in excess of her gambling winnings for each of the three years following the years at issue in Chow I, i.e., the years at issue here, 2006, 2007, and 2008.

That additional information about her failure to become profit meant that, this time, it was no longer a close case. The Court found she clearly did not have a profit motive and, in fact, sustained the IRS's assertion of penalties against the taxpayer.

Often taxpayers believe that a single victory against the IRS is "proof" that it's OK to do whatever they have been doing. Sometimes it is due to actually surviving an examination, but in many cases it's simply that they've "heard" that their friend has been doing "x" for years and either has never had the position questioned or claims to have survived an exam.

Specifically, this case also makes clear that a taxpayer can likely persuade a court they have a legitimate profit motive for a period of time while sustaining losses so long as there's some evidence to support the view, but eventually continuing losses are likely to overcome any other evidence.

It strains credulity to expect a Court to accept a taxpayer's assertion of an actual profit motive in the face of sustained losses. Clients who act reasonably and shut down an operation that they may have believed had a decent chance of being profitable are far more likely to retain tax benefits than those that keep slogging forward even though the losses keep piling up.

And that's true even if the activity has survived an examination (or even a court challenge) in earlier years.

Section: 223
HDHPs Allowed to Offer Preventive Care Required Under Affordable Care Act and Retain HDHP Status

Citation: Notice 2013-57, 9/9/13

In Notice 2013-57 (www.irs.gov/pub/irs-drop/n-13-57.pdf) the IRS expanded allowable "preventive care" that can be provided under a high deductible health plan (HDHP) to include not only the types of care found in Notice 2004-23 and Notice 2004-50.

Rather, the HDHP may also offer any preventive care required under the Affordable Care Act's provisions found under section 2713 of the Public Health Act. Generally the Affordable Care Act requires group health plans and health insurance issuers offering group and individual health insurance coverage to offer coverage without cost sharing for certain preventive services.

Such required services go beyond those services allowed under the prior notices for coverage to be deemed HDHP coverage. Without this change, it would have been effectively impossible to obtain a qualifying high deductible plan, a necessary precondition to being able to fund a health savings account (HSA).

Section: 280A
Tax Court Analyzes Application of Rules on Personal Use to Vacational Rental

Citation: Van Malssen v. Commissioner, TC Memo 2014-236, 11/20/14

In the case of *Van Malssen v. Commissioner*, TC Memo 2014-236, the Tax Court took at look at applying the "counting days" for §280A to determine if the vacation home rules applied to a property that was used for personal purposes and rented out

The key provisions of the law were summarized by the Court as follows:

> Generally, no deduction is allowed with respect to the personal residence of a taxpayer. Sec. 280A(a); see also *Langley v. Com*missioner, T.C. Memo. 2013- 22, at *5. A dwelling unit is a residence if the taxpayer uses the dwelling for personal purposes for a number of days which exceeds the greater of 14 days or 10% of the number of days during the year for which the unit is rented at a fair rental value. Sec. 280A(d)(1); see also Langley v. Commissioner, at *5. In general, if a taxpayer uses a dwelling unit for personal purposes for any part of a day, that day is counted as a personal use day. Sec. 280A(d)(2). Pursuant to section 280A(d)(2), if the taxpayer is engaged in repair and maintenance of the residence on a substantially full-time basis for any day, such use will not constitute personal use of the residence. See also *Twohey v. Commissioner*, T.C. Memo. 1993-547.

> Personal use also includes use by qualifying relatives under section 267(c)(4). Sec. 280A(d)(2)(A). If a qualifying relative uses the property, then this use will be imputed to the owners unless that individual is both renting the dwelling at fair rental value and also using it as a principal residence. Sec. 280A(d)(2)(A), (3)(A); see also *Kotowicz v. Commissioner*, T.C. Memo. 1991-563. Whether a property is leased for a fair rental value is determined on the facts and circumstances of each case, including consideration of, among other things, comparable rents in the area. See sec. 280A(d)(2)(C). Whether a property is used as a principal residence depends on the facts and circumstances. Sec. 1.121-1(b), Income Tax Regs.
>
> Section 280A(c) lists exceptions to the general rule in section 280A(a). Paragraph (3) of subsection (c) provides that "[s]ubsection (a) shall not apply to any item which is attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e))." In general, subsection (e) requires a taxpayer who uses the dwelling unit for personal purposes during the taxable year, as a residence or otherwise, to limit his or her deduction to the amount determined after applying the percentage obtained by comparing the number of days the unit is rented to the total number of days the unit is used. *Bolton v. Commissioner,* 77 T.C. 104, 111-113 (1981), *aff'd*, 694 F.2d 556 (9th Cir. 1982). However, days spent performing repairs and maintenance generally do not count as days of "use." Sec. 280A(d)(2) (flush text). Paragraph (5) of subsection (c) further limits the deduction authorized in the case of rental use of a residence to the excess of the gross rental income over the portion of the expenses otherwise allowable (such as mortgage interest and taxes) that are attributable to the rental use. In other words, any net rental loss cannot be offset against unrelated income. See *Feldman v. Commissioner*, 84 T.C. 1 (1985), *aff'd,* 791 F.2d 781 (9th Cir. 1986). Therefore, even if petitioners' personal use exceeds the thresholds provided in section 280A(d), we still must characterize the days petitioners used the condominium as either personal use or repair and maintenance days for purposes of the section 280A(e) calculation.

In this case the key issues were whether the taxpayer's rental of the property to his brother had to count as personal use of the property and how many of the taxpayer's own days at the property could be excluded as repairs and maintenance exempt from being counted as personal use of days.

As was noted above, the brother's use would be treated as personal use unless the taxpayer could show a) that he was charged and paid a fair market rent and b) the property was the brother's principal residence during the time it was rented. The Court noted that the taxpayer did not actually prove the brother paid rent, nor that it was market value, but that in the end wasn't relevant because there was no indication that the property was the brother's principal residence for the seven days he rented it. Thus, under §280A(d)(2) the use would be counted as personal.

The taxpayers fared somewhat better on the question of maintenance vs. personal use time. The court evaluated the trips in detail. Most were allowed to be excluded, but the Court noted that this was an "all or nothing" issue for each trip. If the majority of time was spent by the taxpayer in performing repairs and maintenance on the property, then none of the trip (including travel days) count as personal. But if an equal amount of time was as recreational and work days, or if the recreational days outnumbered the work days, then all of the days (including travel days) would count.

In the end the taxpayer was found to have more than 14 days of personal use in each of the affected years, thus the vacation home limitations were triggered, with the losses limited in each case.

Section: 280A
Office in Home Rules Applied to RV, No Deduction Allowed Despite Showing of Business Use

Citation: Jackson v. Commissioner, TC Memo 2014-160, 8/7/14

There were two issues raised by the IRS in the case of *Jackson v. Commissioner*, TC Memo 2014-160, http://www.ustaxcourt.gov/InOpHistoric/JacksonMemo.Wherry.TCM.WPD.pdf. The taxpayers prevailed on the first IRS objection to their deductions, but unfortunately the IRS was able to use the "office in home" rules of §280A to still prevail in denying the taxpayer a deduction—even though this home had wheels.

The issue involved expenses incurred by the taxpayer for a recreational vehicle (RV) that they claimed they were using to sell insurance. Mr. Jackson sold various forms of insurance, but his interest in RVs caused him to discover what he felt was an opportunity for him.

He noted that traditional car insurance did not really "fit" with higher end RVs. He noted this because he had been a member of RV clubs since 1995 and regularly attended RV rallies put on these organizations. At the rallies, held about once a month on a weekend, RV owners would gather with their RVs for a general social event and also had time for information sessions related to RV topics such as maintenance.

In 2004 Mr. Jackson decided that he could use his attendance at these rallies not just for the social purposes he had previously used them for, but also to sell specialized RV insurance policies. He began marketing his insurance at the rallies and, in fact, at least one person who had attended the rallies called Mr. Jackson, frankly, a nuisance regarding insurance.

Mr. Jackson claimed expenses related to his RV as part of his insurance business beginning in 2004.

The IRS objected first that these were primarily social events and that Mr. Jackson did not show a significant enough relationship to his business to allow for a deduction. The Tax Court, looking at the facts of the case rejected this view.

The Court noted that it is perfectly possible to convert what had been a personal, social activity into a business activity if the facts supported that view—and the Court found they did here. The Court found that a significant portion of the expenses incurred had a reasonable relationship to Mr. Jackson's business and, therefore, in general would have been deductible under §162.

But the Court agreed with the IRS that there was a second problem that blocked the deduction—the office in home rules of §280A.

IRC §280A(c) provides generally that:

> Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

An exception to that rule is found at IRC §280A(b)(c)(1) which allows:

> Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is *exclusively* used on a regular basis—
>
>> …(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, …

First the Court noted that an RV has been held under the law to be a qualified dwelling unit—the fact that has wheels and can move on its own doesn't change the fact that it is a self-contained "residence" of sorts.

Being a dwelling unit no deduction will be allowed, even if clearly used for business purposes, if the rules of §280A are not met.

In this case the court found the taxpayer did regularly meet with clients in the RV—but there was no portion of the RV *exclusively* used for that purpose. For that reason, no deduction was allowed.

Section: 280A
Court Allows for Unavoidable Personal Use of Office Portion of Studio Apartment, Grants Deduction

Citation: Miller v. Commissioner, TC Summary Opinion 2014-74, 7/28/14

In the case of *Miller v. Commissioner,* TC Summary Opinion 2014-74, (http://ustaxcourt.gov/InOpHistoric/MillerSummary.Guy.SUM.WPD.pdf) the Tax Court dealt with the issue of whether a studio apartment of 700 square feet could qualify as an office in home for an employee. In particular, the IRS objected to the fact that there had been minimal personal use of the area of the apartment designated as the "office" area, something virtually impossible to avoid in 700 square foot studio apartment.

Laura Miller had been hired by a Los Angeles based public relations, marketing, and advertising services firm to be the entity's account director in New York City. When she was hired Laura worked out of a client's showroom, as the organization had no offices in New York City and Laura was the firm's only employee. However, the employer's relationship with that client ended up being terminated shortly after Laura was hired, so the employer asked her to work from her studio apartment until the firm could obtain commercial space in New York. However, the company never did obtain that space, so Laura continued to use her studio apartment as the company's office in New York City.

Under IRC §280A(c)(1), one of the key requirements to obtain a deduction for office space in a taxpayer's residence is that the area in question must be used exclusively on a regular basis as the taxpayer's principal place of business. As well, as an employee this deduction will only be allowed if the exclusive use of the office space was for the convenience of the employer, rather than the employee. [IRC §280A(c)(1)]

The Tax Court was not troubled by a small amount of personal use (which arguably meant it was not "exclusively" used for business), finding it was "wholly attributable to "the practicalities of living in a studio apartment of such modest dimensions." The Court cited to a 1981 decision in the case of *Hughes v. Commissioner,* TC Memo 1981-140 where the court accepted that that the taxpayer's of space in his studio apartment to walk to and from his bathroom did not destroy the deduction.

However, unlike the *Hughes* case, in this case it was not suggested that her use was for such limited purposes.

The fact that the office in home was for the convenience of her employer was established by the fact that she regularly inquired about when the company would obtain commercial space in New York and was reassured it would be soon. As well, she was aware the Company was having a difficult time financially, particularly in keeping open a New York office, so she continued to accept the arrangement.

As is noted by reference to the *Hughes* case, this is not the first time that the IRS has allowed an office in home for a studio apartment. And, as was noted, the Court does recognize that the single room arrangement means that a very strict reading of "exclusive use" is not reasonable.

However, the Court has not been so accommodating outside of the studio apartment setting. For an example, see the case of *Rayden v. Commissioner,* TC Memo 2011-1. In that case the Court found:

> Petitioner contends that 70-71 percent of his home was used exclusively and regularly for business during the 2004 tax year. As the Court did in *Hefti* , we find it implausible that the taxpayer and his family "had no social or personal life in any portion of the residence other than a few bedrooms and the kitchen." Id. During his testimony petitioner acknowledged a few occasional uses of other rooms for personal purposes during 2004. Nevertheless, because personal use was allegedly minimal compared with business use, petitioners contend that they should be allowed the claimed expense deduction. We appreciate petitioners' contention, but Congress has made it clear that this is not the law.

The *Rayden* court did allow for mere passage from one room to another without losing status as an office in home, but virtually any other use will cause loss of status. If there are actual walls between the rooms, the Court is likely to find it less plausible that personal use for other than mere passage from one room to another is unavoidable.

Section: 402
IRS Modifies Allocation of Before and After Tax Amounts Rolled Over from Retirement Plans

Citation: Notice 2014-54 and REG-105739-11, 9/18/14

In Notice 2014-54 the IRS revised the treatment of amounts rolled over from qualified retirement plans in the allocation of before and after tax amounts held in the plans, as well as amounts held in Roth accounts.

Under the notice, all disbursements of benefits that are scheduled to be made at the same time (disregarding differences due to reasonable delays related to plan administration) will be treated as a single distribution without regard to whether a participant has directed the distributions be made to multiple destinations or to a single destination.

If the pretax amount of the distribution is less than the amount that is directly rolled over to one or more retirement plans, the entire pre-tax amount is assigned to the amount that is rolled over. If more than one destination was designated by the recipient of the distribution, the recipient can allocate the pretax amount among the various accounts as he/she chooses to direct. However, the recipient must inform the plan of the allocation prior to the time of the direct rollovers—that is, the recipient can't wait until a later date to make the allocation.

If the pretax amount with respect to the aggregated disbursements in a distribution equals or exceeds the amount of the distribution that is directly rolled over to one or more eligible retirement plans, the pretax amount is assigned to the portion of the distribution that is directly rolled over up to the amount of the direct rollover. Or, to put it more simply, all amounts directly rolled into the various accounts are treated as pre-tax amounts. If the taxpayer makes any 60 day rollovers (that is, other than the trustee-to-trustee transfers) then the remaining pre-tax amounts are allocated to those. If the 60-day rollovers are greater than the remaining pre-tax amounts and made to multiple accounts, the recipient can allocate the pre-tax amount among the rollover accounts.

As you might expect, if the taxpayer's combined direct and 60-day rollovers are less than the pre-tax amounts the remaining pre-tax distribution is taxable to the recipient. The final amounts to be counted are the after-tax distributions.

The notice indicates that though multiple disbursements may be treated as a single distribution under these rules, the instructions to Form 1099R may require treating the distributions as separate distributions for reporting purposes. In preparing the Form 1099R the plan administrator must take into account the allocation rules provided in this Notice.

The IRS provides the following four examples of the operation of these rules:

> **Example 1**. Employee C participates in a qualified plan that does not contain a designated Roth account. Employee C's $250,000 account balance consists of $200,000 of pretax amounts and $50,000 of after-tax amounts. Employee C separates from service and is entitled to, and requests, a distribution of $100,000. Under § 72(e)(8), the pretax amount with respect to the distribution is $80,000 ($100,000 x $200,000/$250,000). Employee C specifies that $70,000 is to be directly rolled over to the qualified plan maintained by his new employer and that $30,000 is to be paid to Employee C. Because the pretax amount exceeds the amount directly rolled over, the amount directly rolled over to the new plan consists entirely of pretax amounts. The amount paid to Employee C (prior to application of withholding) consists of $10,000 in pretax amounts and $20,000 in after-tax amounts. Prior to the 60th day after the distribution, Employee C chooses to roll over $12,000 to an IRA. Because the amount rolled over in the 60-day rollover exceeds the remaining pretax amounts, the amount rolled over to the IRA consists of $10,000 of pretax amounts and $2,000 of after-tax amounts.
>
> **Example 2**. The facts are the same as in Example 1, except that Employee C chooses to transfer $82,000 in direct rollovers -- $50,000 to the new qualified plan and $32,000 to an IRA. The remaining $18,000 is paid to Employee C. The new qualified plan separately accounts for after-tax contributions. Because the amount rolled over exceeds the pretax amount, the direct rollovers consist of $80,000 in pretax amounts and $2,000 in after-tax amounts. Employee C is permitted to allocate the pretax amounts between the new qualified plan and the IRA prior to the time the direct rollovers are made.
>
> **Example 3.** The facts are the same as in Example 2, except that the new qualified plan does not separately account for after-tax contributions. In this case, it is impermissible for the $2,000 (which represents the after-tax portion of the distribution) to be rolled over to the new qualified plan. Thus, the entire $50,000 rolled over to the plan must consist of pretax amounts. The $32,000 rolled over to the IRA consists of $30,000 of pretax amounts and $2,000 of after-tax amounts.
>
> **Example 4**. The facts are the same as in Example 1, except that Employee C chooses to make a direct rollover of $80,000 to a traditional IRA and $20,000 to a Roth IRA. Employee C is permitted to allocate the $80,000 that consists entirely of pretax amounts to the traditional IRA so that the $20,000 rolled over to the Roth IRA consists entirely of after-tax amounts.

The allocation rules in the notice would apply to distributions taking place on or after January-1, 2015.

Along with the notice the IRS issued proposed regulations (REG-105739-11). The Notice summarizes the proposed regulations as shown below:

> The proposed regulations would limit the applicability of the requirement in § 1.402A-1, Q&A-5(a), applicable to distributions from designated Roth accounts that "any amount paid in a direct rollover is treated as a separate distribution from any amount paid directly to the employee." Under the proposed regulations, that separate distribution requirement would not apply to distributions made on or after the applicability date of the Treasury decision finalizing the proposed regulations. The applicability date of the regulations is proposed to be January 1, 2015. However, in accordance with § 7805(b)(7), taxpayers are permitted to apply the proposed regulations to distributions made before

> the applicability date, so long as such earlier distributions are made on or after September 18, 2014 . For distributions from designated Roth accounts, the allocation rules of section III of this notice will apply to distributions made on or after the applicability date.

The notice also contains special provisions for distributions made in 2014 before the beginning of 2015 (when the Notice becomes effective):

> For distributions made on or after September 18, 2014 but before the allocation rules of section III of this notice apply, taxpayers may apply a reasonable interpretation of the last sentence of § 402(c)(2) to allocate after-tax and pretax amounts among disbursements made to multiple destinations. In the case of such disbursements, a reasonable interpretation of the last sentence of § 402(c)(2) includes utilizing the separate distribution allocation rule described in § 1.402A-1, Q&A-5(a). For example, it would be reasonable for a plan administrator to treat each disbursement as a separate distribution that receives a pro rata share of pretax amounts and for the recipient to determine taxability in accordance with that allocation. It would also be reasonable for the plan administrator to allocate pretax amounts in the manner described in section III of this notice as timely selected by the recipient of disbursements made to multiple destinations. In addition, it would be reasonable for a plan administrator to switch from allocating pretax amounts using the separate distribution allocation rule to allocating pretax amounts in the manner described in section III of this notice as timely selected by the recipient.
>
> For distributions made prior to September 18, 2014, taxpayers may generally apply the same reasonable interpretation standard described in the preceding paragraph. However, if such a distribution is made from a designated Roth account, the allocation of the pretax amounts must be made in accordance with the rules set forth in the § 402A regulations that were in effect on the date of the distribution.

The IRS also announced that the safe harbor explanations to be provided to distribution recipients will be modified to reflect the changes in this notice. Thus, administrators will need to watch for the changes to be made safe harbor explanations if the old safe harbor explanations are being used (which is likely) for plan distribution recipients.

Section: 402
IRS Allows Taxpayer to Rollover Excess RMD Distribution Where Taxpayer Was Erroneously Advised He Could Combine RMDs from IRAs and Qualified Retirement Plan Accounts

Citation: PLR 201406023, 2/7/14

In PLR 201406023 (http://www.irs.gov/pub/irs-wd/1406023.pdf) we run into a unique situation regarding rollover problems from an IRA. In this case, as will become clear shortly, the taxpayer had no intent to rollover the distribution he received from his IRA. However, the IRS ultimately still allowed the taxpayer to roll the funds over when he later decided to do so following the expiration of the 60-day rollover period.

That may strike many as highly unusual, since the IRS traditionally has insisted that the requesting party indicate that he/she intended to rollover funds but was unable to do so. So why is this one different?

In this case the problem related to required minimum distributions (RMD), something the taxpayer in this case was required to take each year. When a taxpayer is subject to the RMD rules, distributions from an IRA are considered to be the RMD and not eligible rollover distributions until the RMD amount has been taken from the IRA.

The taxpayer in this case had three different retirement accounts—one held in a traditional qualified retirement plan, an IRA account designated as a SEP-IRA and an IRA account with no such designation. The taxpayer had a financial adviser calculate the RMD separately for each plan.

The adviser erroneously informed the taxpayer that the entire RMD for all of the accounts could be taken from any single account, rather than having to take the calculated amount for each. While that was true for the two IRA accounts (the total amount due from SEP-IRA and other IRA account could come from either), the employer plan RMD must be taken from that particular plan.

In this case the taxpayer took the total of the three RMD amounts from the SEP-IRA account in January. Since RMDs cannot be rolled over, the taxpayer did not believe any of the distributions were eligible for rollover and had no intent to do so at that time.

In September the plan administrator of the employer plan informed the taxpayer that he was required to take the RMD for that plan from that plan—that is, the administrator gave the correct guidance. The good news would be that the "excess" distribution from the SEP-IRA was eligible to be rolled over since it was no longer blocked by the RMD rules. The bad news was that more than 60 days had elapsed since the distribution was taken—thus, the taxpayer was past the date when the balance could be rolled over.

The taxpayer first attempted to get the IRA custodian to reverse the transaction, but the custodian refused to do so. So the taxpayer now rolled the excess distribution back into the retirement plan and then took the RMD from the retirement plan.

Following all of this the taxpayer asked the IRS to waive the 60-day rollover rules. In this case the IRS agreed to the after the fact waiver.

One item of interest is that the Plan actually accepted the late rollover. The facts of the case do not indicate if the party who allowed the plan to make the deposit was aware of the fact the 60 period had expired, or if the taxpayer him/herself was authorized to act on behalf of the plan (a very real possibility if the plan had been sponsored by a business controlled by the taxpayer).

Certainly it appears that taking the funds would have been a risky move for the plan if the plan representatives were aware the funds no longer met the 60-day requirement. Had the IRS not waived the rollover rules, the plan would have been in the position of knowingly accepting ineligible funds—not a good situation for the plan.

The author would be very wary of advising the plan to accept such funds in a case like this. While the IRS approved the transaction in this case, the result might not have been as positive had, for instance, the adviser not been willing to admit he/she gave bad advice or, in fact, it was the taxpayer and not the adviser who made the decision to combine the total and take it from one account without confirming that this would work.

Section: 402
Sixty Day Period for Rollover Does Not Begin Until Participant Actually Receives the Check

Citation: PLR 201330047, 7/26/13

In Private Letter Ruling 201330047 (http://www.irs.gov/pub/irs-wd/1330047.pdf) the IRS refused to rule on a taxpayer's request for a waiver of the 60 day period for rolling over a distribution from a retirement account. But in this case it actually was good news—for the IRS ruled that the actual rollover, not being made late, did not require a grant of relief by the IRS.

In December the taxpayer received a statement from his former employer showing that a distribution was made from his account to him. The taxpayer contacted the former employer asking about the distribution, as he had not received any check. The employer told the taxpayer that a check had been mailed to him earlier in December.

The check never did arrive, and in February the employer reissued the check to the employee who deposited the amount to an IRA in March. The deposit was more than 60 days after the original check was mailed by the plan. The taxpayer asked the IRS to waive the 60 day rollover due to his own medical condition and that of his mother which caused him to fail to meet the 60 day period from the original issuance date.

The IRS ruled that, in fact, he had not been late. The beginning of the 60 day period was not when the check was originally issued by the plan, but rather when the check was actually received by the taxpayer.

Section: 408
Self-Directed IRA Late Rollover Relief Denied Where Taxpayer Failed to Provide Required Valuation to Custodian

Citation: PLR 201446035, 11/14/14

Officially PLR 201446035 asked (without success) for permission to make a late rollover. But the ruling suggests that the IRS's concerns regarding various forms of "self-directed" IRAs (often SMLLCs formed with the IRA as the only member to hold a specific asset) may also have been involved in the denial.

In the case in question the taxpayer had an IRA with a custodian that was established in 2005. In that IRA the taxpayer formed a "single member [redacted]" which invested in certain property. While the exact form of entity was redacted, it seems very likely that "LLC" or something very similar was the type of entity in question.

In 2011 the taxpayer received a CP2000 indicating that there had been a distribution of this property from the IRA in 2009. The taxpayer claimed he wasn't aware of this distribution. The PLR goes on to note:

> Taxpayer contacted Financial Institution A to inquire about the distribution of Property, upon which time he discovered that Financial Institution A was sold to Financial Institution B. A representative from Financial Institution B informed Taxpayer that Property was distributed because Taxpayer failed to provide Financial Institution B with an annual market valuation as was required to maintain an IRA.

The taxpayer claimed that he failed to timely complete a rollover because he did not receive notice of the distribution until after the end of the 60 day period.

However, the taxpayer did not assert that he had actually complied with the requirement to provide a valuation for the year in question, nor that no such requirement actually existed. Thus, one reason the IRS denied relief was because the problem was not so much an error on the part of the financial institution, but rather a failure of the taxpayer to comply with the requirements of his agreement with the custodian.

But more troubling is the other reasons the IRS gave for denying relief. The ruling states that "taxpayer has not provided sufficient evidence establishing Property *was held in an IRA* and *precisely when Property was distributed* from IRA."

While not clear, it seems likely that this is an indirect reference to the IRS's belief that such arrangements often run afoul of the prohibited transaction rules found in IRC §4975. If an IRA enters into a prohibited transaction, no matter how minor, the entire balance of the IRS is treated as immediately distributed to the beneficiary.

In two cases in 2013 (*Ellis v. Commissioner*, TC Memo 2013-245 and *Peek v. Commissioner*, 140 TC No. 12) the IRS succeeded in getting the Tax Court to find that such trivial actions as a guarantee of the entity's debt by the beneficiary or paying salary to the beneficiary for work actually done were prohibited transactions in "self-directed IRAs" that held operating businesses. But in both cases the IRS also asserted (though the Tax Court did not find) that the transactions to form the entity themselves were prohibited transactions.

Assuming the IRS continues to look at such transactions that way, it seems likely that the IRS will not grant 60 day rollover relief if issues arise should a taxpayer request relief.

Certainly it seems likely that, if the situation had been one where a brokerage firm failed to send the taxpayer a copy of a Form 1099R or information on the distribution, the IRS very well would have granted relief based on financial institution error.

Section: 408
Date of Actual Transfer of Shares to Beneficiary, and Not Date Shown by Custodian on Form 1099R, Controlled to Determine Validity of Rollover

Citation: PLR 201446033, 11/14/14

Taxpayer faced with a Form 1099 containing erroneous information may find that the issuer will refuse to issue a revised Form 1099 no matter how much evidence is produced to show the 1099 is in error. However, the actual tax result depends not on what's on the Form 1099, but rather what actually happened.

The National Office made this point clear in PLR 201446033 where the issue was the date of a distribution from an IRA.

The problem started when the taxpayer's IRA custodian notified the taxpayer that it would no longer hold investments in a particular entity. Thus the taxpayer needed to find a new custodian to hold the investments. However the process got just a bit complicated.

As the facts are described in the ruling:

> Taxpayer A maintained IRA B with Financial Institution C. On June 28, 2013, Financial Institution C notified Taxpayer A that it would no longer hold investments in Company D within his IRA (IRA B). IRA B held two investments in Company D: Security M shares with a total value of Amount 1 and Security N shares with a total value of Amount 2. Taxpayer A received a notice from Financial Institution C that if Financial Institution C did not receive instructions from Taxpayer A by September 7, 2013, regarding the disposition of Securities M and N, Financial Institution C would make a taxable distribution to Taxpayer A of all the Security M and Security N shares themselves. On July 26, 2013, Taxpayer A completed an account transfer form with Financial Institution F which authorized the direct transfer of both Security M and Security N shares held by IRA B to a new IRA with Financial Institution F which Taxpayer A intended to open. The transfer never occurred because Financial Institution F could not accept the Security M and Security N shares because the shares were not retitled in the name of the new custodian, Financial Institution H, and, hence, could not be transferred by Financial Institution C to Financial Institution H.
>
> By letter dated September 26, 2013, Financial Institution C notified Taxpayer A that Securities M and N with values of Amounts 1 and 2, respectively, were removed from IRA on September 12, 2013. By letter dated October 9, 2013, Taxpayer A instructed Financial Institution C to retitle Securities M and N in the name of Financial Institution H as custodian. This instruction was ignored. Taxpayer A submitted a document, prepared by Financial Institution C, which showed the actual distribution date of Securities M and N from IRA B was November 20, 2013. On January 16, 2014, Securities M and

N were deposited into IRA I at Financial Institution G with Financial Institution Has the new custodian. On January 16, 2014, Financial Institution G posted the total of the Security M and Security N shares at cost of Amount 3 (the sum of Amounts 1 and 2) and market value of Amount 3.

Despite the fact that the distributing custodian's statements showed the shares were distributed in November, the Form 1099R that was issued for the year showed the distribution date as September 12, 2013, or more than 60 days before the shares actually left the institution's possession.

Clearly since the taxpayer did not have the shares until more than 60 days after the date shown on the Form 1099R, there was no way the taxpayer could have rolled the shares into another IRA within 60 days of that date. The taxpayer requested that the Form 1099R be changed, but the institution refused to so.

The taxpayer asked the National Office to rule that, in fact, the taxpayer had made a timely rollover and that, in effect, the distribution date shown on the Form 1099R was not the actual distribution date. The taxpayer provided the statement to the National Office showing the date of the distribution.

The National Office agreed that the actual distribution date was the November, rather than September, date. Thus, the Office also agreed that the depositing of those shares with the new custodian in January 2014 was a valid rollover.

Section: 408
IRS Clarifies One Rollover Per IRA Account Holder Rule to Be Applied Beginning in 2015

Citation: Announcement 2014-32, 11/10/14

In Announcement 2014-32 the IRS clarified the application of the "one rollover per IRA holder per year" rule, specifically dealing with two special cases.

Following the IRS victory in the case of *Bobrow v. Commissioner*, T.C. Memo. 2014-21, the IRS determined that, beginning in 2015, it would begin to enforce a one rollover per IRA owner per year limitation, rather than the rule described in Publication 590, *Individual Retirement Arrangements (IRAs)*.

Following that announcement the IRS became aware of certain concerns regarding specific transactions. The announcement clarifies the impact on conversions from traditional IRAs to Roth IRAs, rollovers to or from qualified plans (even though involving an IRA) or trustee to trustee transfers (generally referred to direct rollovers).

Specifically, the announcement holds:

- A rollover from a traditional IRA to a Roth IRA (a "conversion") is not subject to the one-rollover-per-year limitation, and such a rollover is disregarded in applying theone-rollover-per-year limitation to other rollovers. However, a rollover between an individual's Roth IRAs would preclude a separate rollover within the 1-year period between the individual's traditional IRAs, and vice versa.
- The one-rollover-per-year limitation also does not apply to a rollover to or from a qualified plan (and such a rollover is disregarded in applying the one-rollover-per-year limitation to other rollovers), nor does it apply to trustee-to-trustee transfers.

As the ruling notes, "IRA trustees can accomplish a trustee-to-trustee transfer by transferring amounts directly from one IRA to another or by providing the IRA owner with a check made payable to the receiving IRA trustee." Because such transfers are not affected by the "one rollover per year" rule, generally clients should be encouraged to use this mechanism rather than getting a check and then later depositing cash into a new account account. That latter situation is the one that is impacted by the revised rollover rules the IRS will begin enforcing in 2015.

Section: 408
Taxpayer Granted Partial Relief For Failed Transfer of IRA to Custodian That Later Discovered It Was Not Qualified to Act as Custodian

Citation: PLR 201440028, 10/3/14

Although relief is routinely granted to taxpayers who file for a private letter ruling request when they fail to complete a timely IRA rollover due to financial institution error, in PLR 201440028 a taxpayer ran into a situation where the IRS determined it was helpless to grant full relief from what was clearly a financial institution error.

In this case the taxpayer decided he wished to move funds from an IRA held by one institution to another institution as part of his financial plan. The second institution assured the taxpayer that it was an institution authorized to hold IRA accounts. The taxpayer made two separate direct transfers form his old IRA account to the one being held by the new institution.

Unfortunately, the second institution later discovered that it had been in error when it had told the taxpayer that it met the requirements to be an IRA custodian. This error was discovered more than 60 days after either transfer was made. The institution admitted that the problem was caused by its error and the taxpayer sought relief from the IRS to allow the taxpayer to transfer the funds to an institution that was a qualified IRA custodian.

However the IRS ruled that it could only grant relief for one of the two transfers. IRC §408(d)(3)(B) provides that a taxpayer may not rollover a distribution from an IRA if the taxpayer had previously rolled over an IRA distribution during the year prior to the second distribution.

While the taxpayer believed (due to the representation of the financial institution) that he had made two direct rollovers, in fact he had rather taken two distributions within one year. The IRS position is that the agency has no authority to override the clear language of the law absent a specific grant of authority. While Congress granted the right for relief on late rollovers, Congress did not provide for IRS authority to waive the one year rule.

Section: 408
Tax Court Rules, in Split Opinion, That U.S. Civil Service Retirement System Not Required to Take IRA Rollovers

Citation: Bohner v. Commissioner, 143 TC No. 11, 9/23/14

A divided Tax Court issued came to very different conclusions regarding whether a plan that accepts money from employees must offer the option to accept that money as a rollover from an IRA. The plan in question was the United States Civil Service Retirement System (CSRS) and the case was that of Bohner v. Commissioner, 143 TC No. 11. The majority conclusion was that a plan, even if it accepts funds from employees on an after-tax basis, is not required to treat the amount as a rollover contribution if the employee deposits funds within 60 days of withdrawing funds from an individual retirement account.

In the case at hand Mr. Bohner, an employee of the Social Security Administration approaching retirement, received a letter from CSRS indicating that if he paid in a sum of money he could increase the annuity he would receive upon retirement. The letter asked for $17,832 within 15 days from the date of the letter if he wished to qualify for the increased annuity. Mr. Bohner did not have those funds available in his bank account, so he withdrew the funds from an IRA which he had.

The CSRS letter did not say if such a payment would or would not qualify as a rollover contribution—that is, it was totally silent on the matter. Mr. Bohner reasoned that the CSRS was a qualified plan (and he was correct in that view), that qualified plans are allowed to accept rollover contributions from a participant's IRA (which is true, they are allowed to do so), and therefore reasoned that what he did was a nontaxable rollover from his IRA to the CSRS plan.

However, the IRS argued there was a flaw in his logic—while the law allows a plan to accept IRA rollovers, the IRS argued that nothing required a plan to accept IRA rollovers if it accepted employee funds. So, absent a plan provision providing for acceptance of cash from an employee as a rollover contribution (as opposed to having funds directly transferred from the IRA custodian to the plan), the deposit would not qualify as an IRA rollover.

The key question revolves around the reading of IRC §408(d)(3) which governs rollovers, specifically §408(d)(3)(A)(ii) which provides:

> (ii) the entire amount received (including money and any other property) is paid into an eligible retirement plan for the benefit of such individual not later than the 60th day after the date on which the payment or distribution is received, except that the maximum amount which may be paid into such plan may not exceed the portion of the amount received which is includible in gross income (determined without regard to this paragraph).

At first reading (and in the reading of the dissenting judges in this case), that appears to solve the problem. There's no question that Mr. Bohner deposited his funds into an eligible retirement plan (CSRS), as the Code defines such and, as a footnote in the case points out, the IRS has taken that position multiple times. The IRS conceded such in this case.

But, the IRS argues, a plan is not required to accept rollovers under §408(d)(3). The majority of the Tax Court accepted the IRS's view on this point.

While conceding that the IRC is silent regarding whether plans must accept an IRA rollover, the Court found that the situation should be comparable to that found at IRC § 401(a)(31)(E) that dealt with the rollovers from employer sponsored plans. The Court notes that there the law clearly indicated that the plan had to have a provision allowing for such transfers, and quotes from the Senate Committee Report that states "As under present law, a transfer cannot be made to another qualified plan unless the terms of the transferee plan permit the acceptance of such transfer." The Court then concluded that since the law that authorized CSRS to accept payments in this case did not discuss IRA rollovers, the funds were to make up for after-tax contributions that had not been withheld from an employee's salary and the taxpayer did not identify the contribution as a pre-tax contribution, the amount he received from the IRA was taxable to the participant. He will not be double-taxed on the amount—rather, the amount will become part of his basis in the annuity being distributed by the retirement plan.

In a dissent joined by five other judges (and in which another judge principally concurs), Judge Buch argues that the majority issued a decision at odds with the law as written. He rather agrees with the taxpayer's view that the only issues were whether he took a distribution from an IRA that qualified for rollover treatment (he did) and whether he timely deposited those funds into a qualified retirement plan (he did). The law makes no reference to any requirement that a plan must have language permitting IRA rollovers—rather, it simply provides that if the funds properly end up in the plan (which they did) then the IRA distribution is not taxable.

He particular takes the Court to task for reaching out to a totally different portion of the IRC where Congress did require explicit language to authorize a transfer. He notes:

> In looking to analogous provisions to assist in interpreting section 408, the opinion of the Court has done the exact opposite of what canons of statutory construction instruct. Canons of statutory construction encourage courts to look to analogous provisions when resolving ambiguity in the provision under consideration. Atl. Cleaners & Dyers, Inc. v. United States, 286 U.S. 427, 433 (1932) ("Undoubtedly, there is a natural presumption that identical words used in different parts of the same act are intended to have the same meaning."). Where one provision contains a specific rule and another is silent, canons of statutory construction tell us that the omission is intentional. Rand v. Commissioner, 141 T.C. 376, 390-391 (2013). And we should interpret the provision consistent with the omission; we do not add a rule to the statute that Congress did not itself include.

He goes on to note:

> The strongest statutory authority the opinion of the Court can muster is the statement "The statutory provisions governing CSRS do not include a provision allowing pretax employee contributions." See op. Ct. p. 5. But the statutory framework of CSRS also does not include a provision prohibiting pretax employee contributions. A review of that statutory framework reveals that it is silent on the subject of its Federal income tax treatment. 5 U.S.C. secs. 8331-8351 (2006). The only tax-related provisions within CSRS's governing statutes relate to State taxes and withholding. 5 U.S.C. sec. 8345(k).

However, regardless of what the reader might think of the logic of the dissenters, for now the Tax Court's published opinion (and therefore the rule used to resolve future cases) is that CSRS is not required to accept IRA rollovers and, as such, a taxpayer facing the same situation as Mr. Bohner will be taxable on the amounts taken out.

Section: 408
Failure to Follow Provisions of §408(d)(6) and Divide IRA Account Results in Taxable Income to IRA Owner Along With No Offsetting Alimony Deduction

Citation: Laremore v. Commissioner, TC Summary Opinion 2014-94, 9/18/14

In the case of *Laremore v. Commissioner*, TC Summary Opinion 2014-94, a taxpayer found out the hard way that solutions that look to be economically identical can have extremely different tax consequences.

Mr. Laremore's situation involved his divorce and an IRA account he had. As part of the divorce decree his IRA was supposed to be divided with his former spouse. The parties had agreed to have a qualified domestic relations order drawn up to divide the IRA (though a QDRO is not necessary for an IRA—but it certainly adds to the story).

Their decree provided that they were to divide their retirement accounts equally. However the parties discovered their numbers for the balances in the retirement accounts did not agree when they went to finalize matters.

They had a discussion regarding the issue and on the record in the family court Mr. Laremore's counsel stated:

> We're recognizing that the numbers on the IRA's or retirement accounts may be slightly off, but the concept here is that whatever was in those accounts at commencement, plus the growth on them, *equally belongs to the parties*. * * *

> And so to the extent that we need to look at statements and do a little tweaking on the number, we will, but *the concept of what we're doing is there.*

However getting these details worked out proved to be a problem. The fact that Mr. Laremore moved to another state also likely complicated matters.

Drafting the QDRO proceeded at a rather slow pace. As the Tax Court noted:

> From 2007 to 2009 Mrs. Laremore's counsel attempted on three occasions -- but at an apparently slow pace -- to file the QDROs, yet all three attempts had various defects. Rather than continuing her attempts to file a QDRO, Mrs. Laremore sued Mr. Laremore in Suffolk County, New York; and on May 5, 2009, a judgment was entered against Mr. Laremore. Mrs. Laremore directed that the judgment be transferred to Mr. Laremore's home State of Pennsylvania in order to enforce it against him.

Mr. Laremore went ahead and paid the judgment out of non-IRA funds.

Generally under IRC §408(d)(6) a transfer of an IRA account balance from one spouse to another in a divorce can be accomplished tax free if two conditions are met. First, there must be a transfer of the interest in the IRA from one spouse to another. Second, the transfer must take place pursuant to a §71(b)(2) divorce or separation agreement. If that is done, the receiving spouse treats the IRA as his/her own and would be subject to tax when the funds are withdrawn.

That was clearly the expected result when the divorce decree was signed. But we now have the problem that Mr. Laremore paid off the liability with non-IRA funds in response to a court judgment. Thus, the transfer no longer was of the interest in his IRA to his former spouse.

Mr. Laremore reasoned that, since his wife was supposed to have paid tax on the IRA when she took the funds, he should be able to take an alimony deduction for the payment.

The IRS complained that the payment failed to meet three of the four requirements to be alimony for tax purposes. While agreeing that the parties were not part of the same household (the one requirement met), the IRS argued this arrangement failed to meet three other requirements:

- The payment was not pursuant to a divorce or separation agreement;
- The agreement did not designate the payment as one which is not tax alimony and
- The liability to pay the former spouse would not have been extinguished on her death

The Tax Court felt no need to deal with the first two criteria because it held the payment clearly failed the last one—a liability to pay the amount due would have survived his former spouse's death.

There were provisions in the decree that did qualify as alimony (and which the IRS allowed) and the agreement provided that those payments would cease on the death of his former spouse.

But the item before the court was the liability for the retirement account. In the case *Webb v. Commissioner*, TC Memo 1990-540, the Tax Court concluded that a clause in a decree that stated a spouse "shall pay" a set amount to the spouse is an obligation that would survive the spouse's death as, if the amount were not paid prior to the former spouse's death, that individual's estate could sue to force payment.

As the Court noted, the language in the agreement related to the retirement account had similar mandatory language. It stated:

> Similarly, the stipulation of settlement between Mr. and Mrs. Laremore provided:
>
> > The value of Mr. Laremore's IRA's, over Mrs. Laremore's, is $77,730.48. The agreement is that she *will get* half of that sum for $38, 865.24. *She will get* that $38,865.24 via a QDRO being placed on Mr. Laremore's traditional IRA so that that amount *will be transferred to her* and the end result is that the parties *will have equally shared* these retirement accounts. [Emphasis added.]
>
> The language creating the obligation -- "she *will* get" and "that amount *will be transferred to her*" -- imposes a liability on Mr. Laremore that is not made conditional on death or remarriage and that is not qualified in any way by another provision. As in *Webb*, the above-quoted language -- without qualification or language indicating termination at death -- stands in sharp contrast to a later section of the stipulation of settlement providing for maintenance payments, where the agreement expressly states that the maintenance payments would terminate in the event of Mrs. Laremore's death or remarriage

Though the Court agrees that clearly the result is going to burden Mr. Laremore with a tax that he was not expected to bear under the decree when he eventually takes out the IRA funds that should have gone to his wife in lieu of the other funds, that nevertheless is the law.

The case does leave some questions unanswered, including why the parties felt a need for a formal QDRO since the IRA was not a qualified plan, what were the deficiencies in the QDRO that the ex-spouse's counsel drew and why the New York eventually felt the need to impose a judgment rather than simply require a valid document to be presented which Mr. Laremore would be required to execute—that is, there appears to be a number of "additional facts" we are not privy to.

But what is clear is that the rules regarding what may be treated as alimony are very mechanical—and the "liability for payments continue beyond death" problem is that one that most often trips up individuals who have alimony deductions denied in the Tax Court.

Section: 408
IRA Payment Postmarked by April 15, or Verbal Instruction Given to Institution by April 15, Sufficient to Make Timely IRA Contribution

Citation: PLR 201437023, 9/13/14

In PLR 201437023 the IRS clarified that an IRA (as well as a Coverdell Education Savings Account) custodian can treat a contribution postmarked on or before the unextended due date for filing a return as a contribution for that year. That is true even if the payment does not arrive at the custodian's location until after that filing date (most often April 15).

As well, the ruling provides the same rule will apply if the taxpayer makes even a verbal request to the custodian for transfer from a non-retirement account on or before that date.

The IRS notes that, under IRC §7502(a)(1), the postmark date on the envelope will control in the case of a mailed request.

Section: 408
Despite Admission of Adviser of Giving Bad Advice, IRS Denies Late Rollover Relief

Citation: PLR 201432032, 8/8/14

In many of the IRS rulings granting taxpayers the right to rollover amounts after the 60 day period from IRAs, a financial adviser's admission of having given mistaken advice has proven a key factor in the IRS grant of such relief. However that admission also means that if the IRS does not grant relief, the adviser now has an admission on the record of responsibility for a bad tax result—an admission that will likely prove costing when (not really if) the client seeks economic redress.

In PLR 201432032 (http://www.irs.gov/pub/irs-wd/201432032.pdf) we have just such a case that takes place—the adviser admits to having misinformed the client (and it's very clear that is the case) but the IRS concludes that it would not be proper to grant relief.

In this case a taxpayer wanted to make an investment in a partnership but the custodians of his IRA would not consent to holding the investment. The taxpayer sought advice from his CPA about what could be done in this case.

The CPA did himself have experience in this manner, so the CPA consulted with the compliance department of the wealth advisory firm which employed the CPA and a national accounting firm the was associated with his employer. Following these consultations the CPA told the taxpayer that even though the custodian would not accept an investment in the partnership, he could simply title the investment in the name of the IRA and all would be well.

Unfortunately that's pretty much the same situation a taxpayer encountered in the case of *Dabney v. Commissioner*, TC Memo 2014-108, though in that case the taxpayer did his own research. The Tax Court informed that taxpayer that if the custodian doesn't agree to take on the asset, merely titling it in the name of the IRA is not going to be effective to put the asset in the IRA.

Now let's return to the situation in the PLR at hand: after nearly two years had passed, the CPA discovered that, in fact, merely titling the asset in the name of the IRA was not effective as a rollover. The CPA contacted the taxpayer, advised the taxpayer of the error and suggesting seeking late rollover relief.

In this case the IRS refused to grant relief. The ruling held that the taxpayer "chose to use proceeds from IRA B to fund a business venture rather than attempt to roll the proceeds over into an IRA account for retirement purposes."

While it's not clear what triggered the denial, the IRS's comments on using the funds to start a business venture suggests that it's possible what we have is blown attempt to use IRA funds to start a business.

It's possible (though again we don't know from the limited facts) that the problem was that the taxpayer wanted to keep the funds invested somewhere the IRS did not approve of by using a new custodian. The IRS has been active in challenging attempts by taxpayers to use IRA funds to fund new business start-ups by using the prohibited transaction rules at §4975 against such IRAs, resulting in a deemed distribution of the balance of the account. (See *Ellis v. Commissione*r, TC Memo 2013-245 and *Peek v. Commissioner*, 140 TC No. 12)

If, in fact, the taxpayer proposed not to move the funds in question into "traditional" investments but rather to simply find a "cooperative" custodian to take over holding the partnership interest, then it's not surprising the IRS would refuse to grant relief. In such a case the IRS would likely immediately look for (and under the standards given by the Tax Court in the *Ellis* and *Peek* decisions cited above likely fund) grounds to claim the IRA violated the prohibited transaction rules.

If this is not the case, the ruling would be very troubling since previously the IRS has shown itself willing to grant relief regularly where the taxpayer relied on bad advice that the adviser admits giving.

Section: 408
Financial Institution Under No Obligation to Inform Customer of 60 Day Rollover Rules When Taking a Distribution

Citation: PLR 201432030, 8/8/14

A taxpayer's claimed belief that the institution in which she held the IRA from which she took funds to rollover had an obligation to inform her of the rollover rules was not found sufficient grounds to grant late rollover relief in PLR 201432030 (http://www.irs.gov/pub/irs-wd/201432030.pdf).

The taxpayer took a distribution of IRA funds from a financial institution on September 22, 2012. She deposited them in IRAs with another institution in January of 2013—well after the end of the 60 day period.

The taxpayer claims that the institution from which she took the distribution was her adviser and, as such, had an obligation to tell her about the 60 day rule. However, she did not provide any documentation showing that the institution had taken on the obligation to be her financial adviser.

The IRS held that there was no evidence that the institution had taken the roll of adviser for the taxpayer. And, regardless, an IRA custodian does not have an obligation imposed on it by the IRC to inform customers of the rollover rules when they take a distribution. So unless the institution voluntarily took on that obligation, something that was not shown by the taxpayer, there was simply no error on the part of the financial institution.

Section: 408
Adviser's Assurance that Investment Would Be Returned Within 60 Days Found to Provide Cause to Grant Relief for Late Rollover

Citation: PLR 201431036, 8/1/14

In PLR 201431036 (http://www.irs.gov/irs-wd/201431036.pdf) the IRS granted relief from the 60 day rollover period to a taxpayer who intended to take funds out of the IRA to benefit from a short term investment opportunity—the type of situation that advisers might expect would not lead to an IRS waiver of the rollover period. As you might expect, though, the particular facts of this situation was likely key to obtaining relief.

The taxpayer had been approached by their investment adviser regarding a short term investment opportunity. The adviser told them that they would provide the initial investment amount and would be paid back the principal and interest within the 60 day period, so the funds could then be redeposited into the IRA account. While the ruling does not say so, presumably the IRA funds represented either the only source the taxpayers had to make this investment or, at least, the source from which the funds would be easiest to obtain.

Unfortunately for the taxpayers, things did not go as expected for this investment. Rather, the taxpayers' investment was stolen and then held up in litigation until after the expiration of the 60 day period.

The taxpayers approached the IRS seeking relief. The financial adviser provided a letter confirming that the taxpayers had relied upon his assurance that the funds would be returned within the 60 day window, something that ultimately did not take place.

In prior requests where the taxpayers ran into unexpected issues that held up funds they expected to have before the end of the 60 day period, the IRS has generally denied relief to the taxpayers, asserting that such an expected lack of funds is not one of the issues outlined in Revenue Procedure 2003-16 that would justify relief.

However, Revenue Procedure 2003-16 does provide that one justification for relief is an error committed by a financial institution. In this case, the IRS found that the adviser's assurance that the funds would be returned within the 60 day window amounted to just such a financial institution error and the relief was granted.

To the author it appears clear that relief was granted based solely on the fact that the investment adviser was willing to provide a letter accepting blame for providing erroneous advice to the taxpayers. The result most likely would have been completely different (that is, no relief provided) if the taxpayers had discovered this investment opportunity on their own rather than having had the investment recommended by a financial adviser.

Section: 408
Two Separate Failed IRA Rollovers Found by Court for Two Separate Reasons, But IRS Delays Application of Case Results to Other Taxpayers

Citation: Bobrow v. Commissioner, TC Memo 2014-21, 1/28/14, Announcement 2014-15, 3/20/14, REG-209459-78, 7/10/14

In the case of *Bobrow v. Commissioner*, TC Memo 2014-21 (http://ustaxcourt.gov/InOpHistoric/BobrowMemo.Nega.TCM.WPD.pdf) the taxpayers made two errors with regard to attempted rollovers of IRA distributions.

The first error may have been one of documentation. A deposit that was intended to be a completion of the rollover of an IRA of the wife was deposited into the new IRA account on the 61st day following the distribution, one day late. As well, the amount deposited into the IRA was $25,064 less than the amount of the original distribution.

The taxpayers claimed they had instructed the financial institution to transfer the entire amount of the original distribution to the IRA account prior to end of the 60 day period. The failure to make any transfer by the 60th day or to transfer the entire amount were actually financial institution errors, and the taxpayers had actually made an effective transfer prior to that date.

The Court found, however, that the taxpayers presented no evidence to support this earlier directive. There was neither an admission from the financial institution of the error, nor any documentation provided by the taxpayers of their directive to the financial institution aside from their claim they had done so. Thus the Court found no amount had been properly rolled from the wife's distribution and thus the entire amount was taxable.

The husband's rollovers posed a different problem. On April 14, 2008 the husband requested and received a distribution from his "regular" IRA account with the financial institution in the amount of $65,064. On June 6, 2008 the taxpayer requested and received a distribution from a "rollover" IRA account he held with the same institution in an identical amount to the April 14 distribution.

On June 10, 2008 the taxpayer placed $65,064 into a traditional IRA. On August 4, 2008 the taxpayer placed $65,064 into another IRA.

The IRS disputed the contention that there was a proper rollover of the June 6 distribution. The problem was not that it was past 60 days—it wasn't. Rather, the IRS pointed to IRC §408(d)(3)(B) which provides that a distribution does not qualify for rollover if the taxpayer had received any funds from an IRA account during the one year period prior to the distribution that had been excluded from income under the rollover rules.

In this case, once the taxpayer completed the rollover of the April 14 distribution the taxpayer was not eligible to rollover the June 6 distribution.

The taxpayer attempted to argue that this limitation should apply on an account by account basis. However, the Court noted that the language of the statute does not provide for any such "account by account" test and that the language rather clearly implies that a rollover from any IRA account will taint the beneficiary for a full year.

How a taxpayer come to the conclusion that each IRA is tested separately for this purpose? Although not mentioned as a factor in the taxpayer's decision in this case, in fact Publication 590 (2013 edition) said that such a transaction was just fine. Or, at least, the example given after an explanation that implied the taxpayer could do this does exactly what Mr. Bobrow did.

While the IRS may very well change the wording of Publication 590 following this case (especially since RIA pointed out this issue in their reporting of the case), the 2013 Publication 590 provision is reproduced below:

> **Waiting period between rollovers.** Generally, if you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover.
>
> The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA.
>
> ***Example.*** You have two traditional IRAs, IRA-1 and IRA-2. You make a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3). You cannot, within 1 year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA.
>
> However, the rollover from IRA-1 into IRA-3 does not prevent you from making a tax-free rollover from IRA-2 into any other traditional IRA. This is because you have not, within the last year, rolled over, tax free, any distribution from IRA-2 or made a tax-free rollover into IRA-2.

Even more interestingly, the IRS in 1981 had published proposed regulations (though they never became final) that implemented the same "IRA by IRA" test. Proposed Reg. §1.408-4(b)(4)(ii) also clearly supported what Mr. Bobrow had done.

While it may seem that it is "unfair" for the IRS to take an inconsistent position in court, the reality is that the law and not the publications control outcomes, and the Courts have ruled that the IRS is not bound by either the publications or instructions. And this case is not the first where the IRS has won a case taking a position contrary to a publication.

Similarly the Court effectively ruled that the Code itself denied the option for an IRA by IRA treatment. So the regulation, not only being merely proposed, arguably is at odds with the unambiguous language of the law.

The publications may only be used to establish reasonable cause by a taxpayer seeking to escape penalties—but not the actual tax assessment. However, as a practical matter the publications often will cause an agent to stop pursuing an issue if the text in the publication is pointed out to the agent and clearly applies to the matter at hand.

It may not be coincidental that this "contrary to publications" and "contrary to proposed regulations" ruling does not mention the publication or proposed regulations—it may simply be that neither the taxpayer nor the IRS Counsel ever looked in either place. That appears to have been the case in some prior cases where a "contrary to publications" result has been obtained.

In fact, following the issuance of the decision the taxpayers asked the Tax Court to reconsider its ruling. The American College of Tax Counsel filed an amicus brief supporting the taxpayer's request. In its order, dated appropriately April 15, 2014 (https://www.ustaxcourt.gov/InternetOrders/DocumentViewer.aspx?IndexSearchableOrdersID=131933), the Tax Court denied the request.

The Court first noted that the matter had not been raised by the taxpayer at trial and the taxpayer admitted that it should have been raised prior to the decision. However, the Court went on to explain:

> The Court was aware of the position taken in Publication 590 prior to the issuance of the opinion in this case. Since neither party discussed Publication 590 in their briefs, the Court did not address it in its holding. Regardless, respondent's published guidance is not binding precedent. See *Johnson v. Commissioner*, 620 F.2d 153 (7th Cir. 1980), affg, T.C. Memo. 1978-426; *Carpenter v. United States*, 495 F.2d 175 (5th Cir. 1974); *Adler v. Commissioner*, 330 F.2d 91, 93 (9th Cir. 1964), affg, T.C. Memo. 1963-196. Additionally, taxpayers rely on IRS guidance at their own peril. *Miller v. Commissioner*, 114 T.C. 184, 194-195 (2000), affd sub nom. *Lovejoy v. Commissioner*, 293 F.3d 1208 (10th Cir. 2002). Thus, had petitioners argued reliance on Publication 590 in their briefs, such an argument would not have served as substantial authority for the position taken on their tax returns.

Note that the Court also denied penalty relief in this case, holding that such a reliance would not have constituted "substantial authority" (the trigger for relief from the substantial understatement penalty). All may not lost on penalties, though. Since the parties never mentioned the issue, the Court did not address whether (as seems likely) such reliance would have been reasonable cause that could have granted alternative relief from the penalty. However, since no one claimed to have relied upon this publication, the publication did not serve to mislead the taxpayers (at least not directly--it is still not clear how the taxpayer truly originally arrived at the belief that this worked).

However, following the case the IRS found a bit of an uproar taking place, as financial institutions complained that they had relied upon the publication's statements and their systems were not programmed to reject rollovers in cases where a rollover had been made from another account within the year and their disclosure documents also contained the incorrect (though in line with the IRS Publication) statements regarding allowed rollovers.

In Announcement 2014-15 (http://www.irs.gov/pub/irs-drop/a-14-15.pdf) the IRS announced that it would not apply the Bobrow interpretation that imposed an aggregate limitation on any distribution taking place before January 1, 2015. However, the IRS does indicate in the announcement that it expects to issue regulations that will provide for such an aggregate limit, though not having an effective date before the January 1, 2015 date.

In July the IRS also finally got around to "cleaning up" the hanging proposed regulations. In REG- 209459-78 the IRS officially the withdrew the 1981 proposed regulations.

Many clients have read about the ability to "borrow" from an IRA. In fact, this case appears to be just such a case of a client attempting to use IRA funds for such purposes. However, like this taxpayer, few have ever heard of the "one year" limitation on such rollovers. And, as this taxpayer discovered, ignorance of the provision can prove very costly.

Section: 408
IRA Custodian Not Required to Accept All Possible IRA Investments, Thus Taxpayer Was Not Acting as Agent of Trustee and was Taxable on Transaction

Citation: Dabney v. Commissioner, TC Memo 2014-108 , 6/5/14

Apparently the taxpayer in the case of *Dabney v. Commissioner*, TC Memo 2014-108 (http://www.ustaxcourt.gov/InOpHistoric/DabneyMemo.Vasquez.TCM.WPD.pdf) believed he could get around an IRA trustee's refusal to hold a particular type of asset by simply "assisting" the custodian by titling the asset in the name of custodian.

Mr. Dabney found a piece of undeveloped land which he believed was priced below its fair value. Since he had funds in an IRA with Charles Schwab, he began to consider whether the IRA could take advantage of this opportunity.

He conducted research on the internet and determined that it was possible to use IRA funds to buy real estate. He then called the general customer service line at Schwab and was informed that Schwab did not allow the purchase of alternative investments, a policy which is by far the norm for brokerage firms.

Mr. Dabney also called his CPA to ask him about buying the real estate in the IRA. His CPA informed him that retirement accounts were not his specialty, but after looking over Mr. Dabney's research he agreed that IRAs could invest in real estate.

At this point Mr. Dabney came up with what he felt was the perfect solution to his problem. Unfortunately his solution was not to attempt to find an IRA custodian who would hold "alternative investments" but rather a simpler (though he would find, fatally flawed) alternative.

In 2009 he had Schwab wire the funds directly from the IRA to the seller of the property, and advised the title company handling the closing to have the property titled "Guy M. Dabney Charles Schwab & Co. Inc Cust. IRA Contributory." He had concluded (though the Court does not tell us exactly how) that the property would not need to be managed by the trustee so long as Mr. Dabney did not "use or enjoy the property."

The first problem occurred when, due to a bookkeeping error, the title company erroneously titled the property in the name of the taxpayer himself rather than in the requested manner.

At the end of 2009 Schwab issued a Form 1099R to Mr. Dabney which indicated that he taken a distribution of $114,000 with code "1" (an early distribution to which no known exception applied) on the Form 1099R. Mr. Dabney had completed his paperwork indicating that this was the proper coding, though he believed that, in fact, this was not an early distribution.

Mr. Dabney had hoped to sell the property shortly after buying it, but as it turns out he could not sell the property until 2011. At that point Mr. Dabney discovered the error in titling the property. He sought and received an admission from the title company that the titling was an error on their part. He then had $127,226 (the proceeds from the sale) wired back to Charles Schwab, and marked the deposit as a rollover contribution which Schwab treated as such. Of course, Schwab had never been informed of the fact that, in theory, this was an asset that they had supposedly "held" for nearly 2 years.

The IRS, noticing the original Form 1099R and no custodian reporting having received a rollover of funds, began to look into Mr. Dabney's 2009 return. The IRS determined that Mr. Dabney owed tax on the entire $114,000 distribution as well as the 10% addition to tax for a premature distribution.

The Tax Court was actually fairly understanding of Mr. Dabney's error, but still found that the IRS was correct. The Court pointed out that while the law may allow various types of investments in an IRA, nothing requires a custodian to hold every possible type of investment an IRA account holder might want to make.

The Court distinguished Mr. Dabney's situation from that of the taxpayer in *Ancira v. Commissioner*, 119 T.C. 135 (2002) (http://www.ustaxcourt.gov/InOpHistoric/Ancira.TC.WPD.pdf). As the Court described that transaction:

> During the year in issue the taxpayer requested that his IRA purchase a particular company's (issuing company) stock. The investment adviser informed the taxpayer that, while the issuing company's stock could be held as an asset of the IRA, the custodian would not purchase the stock because the stock was not publicly traded. Subsequently, the investment adviser determined that the IRA could invest in the issuing company's stock if the custodian issued a check payable to the issuing company and the taxpayer delivered the check to the issuing company.

The taxpayer assumed the issuing company would send a stock certificate to the custodian, but the company failed to do so. When the taxpayer eventually discovered the issue he had the company send him the certificate which he then forwarded to the custodian.

The court found in that case that the taxpayer had acted merely as an agent for the IRA custodian and that there had been no distribution even though the stock certificate was eventually delivered to the beneficiary.

In Mr. Dabney's case, unlike that of Mr. Ancira, the custodian had not agreed to accept the asset and, in fact, had a specific policy prohibiting IRAs for which it acted as custodian from holding real estate. Thus, the Court concluded:

> …even if the Brian Head property had been titled as intended, the Charles Schwab IRA could not hold real property and would not have accepted ownership of the Brian Head property. Consequently, we find that Mr. Dabney did not act as an agent on behalf of Charles Schwab and that the Charles Schwab IRA did not purchase the Brian Head property.

As well, the Court noted that the title company never agreed to act as, and was not, an IRA custodian for Mr. Dabney. Thus the wire transfer was not a trustee to trustee transfer (Mr. Dabney's attempted second defense). While it left a trustee, it did not move to a trustee.

While finding Mr. Dabney was liable for the income tax and additional 10% tax, the Court did find that Mr. Dabney was not liable for the accuracy related penalty under IRC §6662.

While the understatement of tax was enough to trigger the substantial understatement provision of IRC §6662(d)(1)(A), the Court found that the taxpayer had acted with reasonable cause and in good faith and thus had relief under the provisions of IRC §6664(c)(1).

The Court noted:

- He was not a sophisticated taxpayer with no background in tax or accounting
- He undertook significant time and effort in determining if the transaction would be free from tax
- He never used the property personally
- He went to the trouble to get the title company to issue a scrivener's affidavit when he discovered the titling error.

Thus, the Court found:

> Although he was mistaken in his understanding of the law, it was reasonable under the circumstances for Mr. Dabney to believe that he had not received an early distribution from his IRA. See sec. 1.6664-4(b)(1), Income Tax Regs. (stating that an honest mistake of law may indicate reasonable cause and good faith). We find that he had reasonable cause for failing to report the distribution on his return and acted in good faith. Accordingly, we hold that Mr. Dabney is not liable for the accuracy-related penalty.

Of course, this isn't really the end of the story, though it's the end of the issue the Tax Court was dealing with. At this point in time Mr. Dabney would appear to have a significant excess contribution to his IRA that was made in 2011.

While it appears Mr. Dabney is subject to the tax on excess contributions, the good news is that, based on the 1997 *Campbell* case, 108 TC 54, he will be given basis in the IRA equal to the amount of the invalid rollover. In other cases if an excess contribution is in excess of the annual deduction amount and not withdrawn by the due date of the taxpayer's return for the year of the contribution, the entire balance is taxable. [See the special rule at IRC §408(d)(5) and its requirements.]

Section: 408
Postal Delay in Delivery Found Sufficient Cause for IRS to Grant Late Rollover Relief

Citation: PLR 201416012, 4/18/14

It turns out the IRS has sympathy for someone who ends up with a check that got delayed in the mail, as pointed out in PLR 201416012, http://www.irs.gov/pub/irs-wd/1416012.pdf.

The taxpayer in this case had taken funds from one IRA custodian in order to transfer the funds to another custodian. For reasons not discussed in the ruling the taxpayer had not deposited the funds as the 60 day period end approached.

Four days before the deadline the taxpayer took checks to be sent to the new custodian to the Post Office. The taxpayer decided to use Priority Mail along with certification, but discovered that the "2 day delivery" wasn't actually guaranteed on that product.

Since it was during the holiday season the taxpayer asked a postal employee whether, given that it was the holiday season and the two day delivery wasn't guaranteed, whether the letter would make it to its destination in time. The taxpayer was assured the letter would arrive by the day before the due date, so he sent it off. He received a receipt showing the expected delivery date as the day the postal employee had assured him it would arrive by.

It turns out the postal employee was a bit off on the actual delivery date. The letter did not actually arrive within the four days, only finally arriving three days after the expiration of the 60 day period.

The taxpayer now turned to the IRS National Office for relief. The National Office determined that his failure was due to the unexpected delay in delivery. What some might find surprising is that the National Office found that cause as good enough to grant the requested relief.

As a practical matter, a client looking to rollover funds should always be encourage to do a direct trustee to trustee transfer, since that totally bypasses the 60 day issue. If the taxpayer does take the funds, the adviser should strongly advise delivering the fund to the new custodian very early in the period. And, if against all advice, the client is still holding the funds four days before the deadline and needs to mail them in, the client should be advised to use a *guaranteed* delivery date service.

But if a client ignores all of that advice, this ruling at least gives the hope that the IRS might be persuaded to grant relief. Note, though, that this taxpayer was able to state that he had specifically asked about the date and retained the receipt that showed the expected delivery date. If the client doesn't at least do that, the IRS might not be so forgiving.

Section: 408
Failure of Brokerage Firm to Timely Deliver Loan Proceeds Did Not Excuse Late Rollover

Citation: Alexander v. Commisioner, TC Summary Opinion 2014-18, 2/26/14

In the case of Alexander v. Commissioner, TC Summary Opinion 2014-18, http://www.ustaxcourt.gov/InOpHistoric/alexandersummarydean.sum.WPD.pdf, the taxpayer found out that "borrowing" from his SEP-IRA is a risky proposition.

The taxpayer had a short term need for $36,000 and his investment adviser decided to advise him of a solution. The taxpayer had a SEP-IRA with the financial institution, and the institution in question also made loans. While the taxpayer was creditworthy, it would take 30-45 days to get the loan.

The adviser suggested the taxpayer could take $36,000 from his IRA account and apply for a loan. When the taxpayer received the loan funds he could then put the $36,000 back in the account. This would allow the taxpayer to get the $36,000 now even though it would take 30-45 days to get the funds.

Unfortunately the loan didn't move forward quite as fast as the adviser suggested, and the funds were not made available to the taxpayer under more than 60 days after the withdraw. By the time his personal check got deposited back in the IRA account more than 60 days had passed.

The taxpayer argued that since the late rollover wasn't really his fault, he should be found to have made a valid rollover. However, the Tax Court refused to grant his request, noting that taxpayers have to comply with the rollover requirements in detail to obtain relief.

The taxpayer then tried to argue that maybe it wasn't a rollover distribution at all--really it was a loan from an employer plan (remember the IRA had been funded with SEP contributions). This appears to "make sense" since under IRC §72(p) loans from (certain) employer plans aren't treated as distributions.

The Tax Court noted that the taxpayer should "be careful what you wish for" when arguing for the loan characterization. The Court points out that IRC §72(p) relief is limited to amounts held in certain specified plan vehicles, and IRA accounts (which are the vehicles which old SEP-IRA contributions) are not one of those vehicles that can qualify for §72(p) loans.

Loans to beneficiaries that don't meet the requirements of IRC §72(p) are generally prohibited transactions under §4975(c)(1)(B). And, per IRC §408(e), if an IRA is involved in a prohibited transaction the entire balance of the IRA is treated as distributed to the beneficiary. So even a $1 loan to the participant would result in the beneficiary being taxed on the entire balance of the account.

The Court decided to save the taxpayer from himself, and found that the taxpayer had not borrowed from the IRA but rather had simply the taxable distribution that the IRS claimed existed when the funds were not returned to an IRA before the expiration of the 60 day period.

Section: 408
Depositing "Rollover" Funds Before Amounts Distributed from Original Account Resulted in Invalid Rollover and a Taxable Distribution

Citation: PLR 201412020, 3/21/14

Details matter when handling an IRA rollover, and in PLR 201412020 (http://www.irs.gov/pub/irs-wd/1412020.pdf) a taxpayer discovered that the law requires waiting until the funds have been disbursed from the IRA the funds are being rolled out of before the taxpayer may deposit funds into the “new” IRA.

In this case the taxpayer was actually looking for relief on two blown rollovers, but the one where relief was denied is more interesting. On July 28, 2010 the taxpayer completed an application for a new account. In early August the taxpayer asked the old custodian to transfer the balance to the new one.

Apparently the old custodian wasn’t in a great rush to transfer the funds and as the end of September 2010 approached the funds still had not been transferred. Patience was apparently not one of the taxpayer’s virtues, so the taxpayer took the amount due from the old custodian out of his checking account and transferred that balance to the new account on September 28, 2010.

On October 1, 2010 the old custodian finally issued a check for the balance of the original account which the taxpayer put into his checking account.

Unfortunately, since no distribution had been made from the taxpayer’s IRA on September 28, 2010, that contribution cannot be a rollover contribution as there was, as of yet, no eligible rollover distribution to start the 60 day clock. The IRS ruled that the taxpayer had not shown a valid reason to grant the right to make a late rollover in this case.

Rollovers (other than direct, trustee-to-trustee transfers) are high risk maneuvers for taxpayers to undertake and generally prudence suggests advising clients to use direct transfers whenever possible. As this ruling notes, the rules are strict and actions that don’t seem to be a problem can still create issues.

Section: 408
Taxpayer Allowed to Return IRA Distribution in Excess of Minimum Required Distribution Where Financial Institution Erred in Computing Minimum Distribution Amount

Citation: PLR 201340023, 10/18/13

A regular event each year for many retirees and their advisers is determining the proper amount of any required minimum distribution from a retirement plan. Often the determination is made by inquiring of the taxpayer’s financial adviser how much of a distribution remains to be taken.

In Private Letter Ruling 201340023 (http://www.irs.gov/pub/irs-wd/1340023.pdf) the IRS granted late IRA rollover relief to a taxpayer based on erroneous advice given to the taxpayer by a financial institution that lead her to take a larger than required minimum distribution for the year in question.

The taxpayer inquired of her IRA custodians regarding how much she had to take as a minimum distribution for the year in question. Her intent was to take only the required minimum distribution for the year. One of the institutions erroneously told her the required amount was larger than it actually was, and she took that larger amount. She later discovered that such a distribution was not necessary when her accountant received a copy of the Form 1099R issued by that institution.

A similar ruling was issued where the taxpayer received similarly erroneous advice, this time because her financial advisers had switched his practice to a new company and, when checking records to see what the minimum distribution should be for the year, did not have access to the records of the organization he used to work through. For that reason, he failed to find that a distribution had been made previously. (Private Letter Ruling 201340024, http://www.irs.gov/pub/irs-wd/1340024.pdf).

Advisers should note that the taxpayers in each case were able to convince the IRS that the taxpayer had specifically inquired of the institutions regarding the minimum amounts required and was able to document the amounts they were told. Most likely the financial institutions corroborated her story, since most often the IRS will demand such an "admission of error" by the institution in order to grant this relief.

Section: 408
No Late Rollover Relief Where Taxpayer Claimed Uncorroborated Verbal Instructions to Institution and Failed to Notice Deposit in Wrong Account on Statements

Citation: PLR 201328036, 7/12/13

While the IRS has the authority to waive late rollovers into IRAs and the IRS has indicated that failures on the part of a financial institution will generally be a reason the IRS will accept in granting a waiver, the taxpayer must shows the failure on the part of the institution. In PLR 201328036 (http://www.irs.gov/pub/irs-wd/1328036.pdf) the taxpayers presented a story that the IRS simply didn't find provided such proof.

The case is one that is full of bad facts. First, both husband and wife in separate transactions managed to foul up IRA rollovers from each of their own accounts. They both claimed they had talked to "an employee" of the institution and directed that they wanted the funds placed in IRA accounts.

However, the funds actually were deposited into a pre-existing account the taxpayers had with the institution. Despite the fact that the taxpayers received regular statements from the institution on this account, the taxpayers claimed they were unaware the funds had made their way into the non-IRA account until they received a notice from the IRS.

The taxpayers did not produce any documents they had filed with the institution directing the funds to IRA accounts, nor did any employee of the financial institution produce a statement to back up their claim that they had given verbal instructions for the funds to be deposited.

Combined with the taxpayer's inability to explain why they had not noticed the "extra" funds in the other account with the institution, the IRS did not find the taxpayers had shown the failure to complete the rollover was due to errors on the part of the financial institution.

Frankly, the taxpayer's story that two separate phone calls had been mishandled by the financial institution and the funds had ended up in the same location seems just a bit incredible.

Likely the IRS suspected that the more likely explanation was that the taxpayers didn't understand that the funds not only had to go to the institution, but had to be held in an account separate from their non-IRA accounts with the institution. The IRS has consistently held that taxpayer error, not related to a medical condition, will not give rise to a grant of relief.

Under Revenue Procedure 2003-16 the IRS outlines the standards that the IRS will apply in determining whether or not to grant a waiver of a late rollover. But the taxpayer must do more than simply recite the magic words "financial institution error" to obtain relief.

Generally the rulings have indicated that the taxpayer is most likely to obtain relief if the institution will produce a statement confessing to error or other documentation establishes that the taxpayer clearly directed the institution to take actions that were not taken, and which resulted in the failed rollover.

As well, the taxpayer is expected to use reasonable care in handling the rollover transaction. In this case the failure of either taxpayer to read the statements and notice two large "extra" deposits appears to show a lack of reasonable care in handling this matter.

Section: 871
Nonresident Aliens Allowed to Measure Gains From Gambling on Per Session Basis

Citation: Sang J. Park and Won Kyung O v. Commissioner, 2013-2 U.S.T.C. ¶50,423, CA DC, 7/9/13, reversing 136 T.C. 569, 6/13/11

In the early part of his opinion in the case of Sang J. Park and Won Kyung O v. Commissioner (2013-2 U.S.T.C. ¶50,423, CA DC, http://www.cadc.uscourts.gov/internet/opinions.nsf/F80DD179A16F848285257BA3004EA6D1/$file/12-1058-1445657.pdf), Judge Kavanaugh wrote:

> After a night of gambling, it's no fun to walk out of the casino a loser. But it's even worse when the IRS, on your way out, tries to tax you on each individual bet that you happened to win over the course of your losing night.

The issue in the case involves the officially informal guidance the IRS issued in 2008 Chief Counsel Memorandum AM2008-11 which held that U.S. gamblers could use a "per session" method of calculating gains or losses from gambling rather than having to account on a "per bet" basis. Thus, if a taxpayer entered a casino with $1,000 to play slots and left at the end of the day with $1,050 the taxpayer had a single "gain" of $50, even if he arrived at that result even though he had gross winning of $10,000 during the day offset by losing pulls of $9,950.

While never issued as officially binding guidance, the IRS had applied this treatment to U.S. taxpayers. The treatment does have a tax effect, since the gains are included in adjusted gross income while the deduction would be treated as an itemized deduction. Since adjusted gross income impacts many tax items, and even non-tax issues like a retiree's Medicare premiums, the difference can be significant for a U.S. taxpayer even if "ultimately" the taxpayer would have deducted the $9,950.

However the IRS had taken the position that the analysis in AM2008-11 did not apply to the taxation of nonresident aliens under IRC §871. Generally nonresident aliens are taxed on gains received from sources inside the United States. As well, nonresident aliens are not allowed the deduction for losses from gambling to the extent of gains under IRC §165(d), making the impact far more significant.

And the difference was truly significant for Mr. Park, a South Korean citizen and resident, who decided (probably now to his regret) to gamble in the United States. As Judge Kavanaugh put it "…Sang Park traveled from South Korea to the United States and, while here, gambled at slot machines. A lot." In fact, the difference in treatment involved a difference of more than $100,000.

While the Tax Court had previously agreed with the IRS's view that per session treatment did not apply to nonresident aliens (136 T.C. 569), the Circuit panel disagreed with this view.

The Court of Appeals found the IRS memorandum persuasive in arguing for a per session treatment of gambling gains, but found nothing in the ruling turned on the question of whether a taxpayer was a U.S.

resident. The Court pointed out that what was measured became the single "gain" or "loss" for that day, and that §165(d) used the same term (gain) as §871 does.

So the Court found that the taxpayer was not circumventing §871 and making use of the §165(d) deduction indirectly to allow what would have been a disallowed deduction for the nonresident alien against the otherwise taxable gain.

Section: 951
Controlled Foreign Corporation Investments in US Subject to Tax to Shareholder Under §951 Are Not Qualified Dividends

Citation: Rodriguez v. Commissioner, 137 TC No. 14, 12/7/11, affirmed CA 5, Docket No. 12-60533, 7/5/13

In the case of *Rodriguez v. Commissioner*, 137 TC No. 14 (http://www.ustaxcourt.gov/InOpHistoric/RodriguezO.TC.WPD.pdf) the IRS and the taxpayer agreed about almost everything regarding the taxpayers' returns for the years in question. The IRS and the taxpayer agreed on the amount of income, including the treatment of income from a controlled foreign corporation as currently taxable to the couple under IRC §§951(a)(1)(B) and 956.

What they did not agree upon, though, was whether those amounts included under IRC §§951(a)(1)(B) and 956 were eligible for treatment as qualified dividends under IRC §1(h)(11).

The taxpayers argued that the amounts should be treated as qualified dividends. The taxpayers pointed to language in the Senate report that accompanied the original enactment of IRC §951 that stated "earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them." The taxpayers also argued that the 2004 instructions to Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, indicated that individuals should report such income as ordinary dividend income.

The Tax Court did not agree with this view. The Court, endorsing the IRS position outlined in Notice 2004-70, found that §951 inclusions are not qualified dividends. The Court found this language did not serve to make the amounts truly dividends, noting that in the case of §951 inclusions no actual distribution is made to the shareholders, that such payments increase the shareholders' basis in the stock (unlike a traditional dividend) and the lack of a "ex-dividend" date made it a "poor fit" for restrictions inherent in the §1(h)(11) provisions.

The Court also reminded us that even if the IRS instructions might have said such payments were dividends (and the Court wasn't sure they truly did that), taxpayers cannot rely on such instructions if they are contrary to law.

On appeal, the Fifth Circuit affirmed the Tax Court's decision (Docket No. 12-60533, 7/5/13, http://www.ca5.uscourts.gov/opinions/pub/12/12-60533-CV0.wpd.pdf).

Section: 1001
NMS (National Mortgage Settlement) Payment Taxation Explained by IRS

Citation: Revenue Ruling 2014-2, 12/18/13

The IRS outlined the treatment of payments received by individuals as part of the National Mortgage Settlement in Revenue Ruling 2014-2 (http://www.irs.gov/pub/irs-drop/rr-14-02.pdf).

The settlement was between the United States government, 49 state governments (Oklahoma was not part of the settlement) and five bank mortgage services related to alleged actions of the lenders during period from January 1, 2008 to December 31, 2011. Individuals who lost their principal residence due to foreclosure during that period and meet certain criteria will receive a payment of $1,400 as part of that settlement.

The settlement payment is treated as a reimbursement of reduced proceeds received on the foreclosure and not as cancellation of debt. The ruling outlines the treatment, and provides a number specific examples.

The ruling provides that the payment relates to the residential portion of the property if the taxpayer used only a portion as a residence in a multi-unit property, and is treated as additional proceeds from the deemed sale of the residential property. Thus it would serve to either reduce a loss on the residence (which, as personal use property, would generally be nondeductible) or increase or create a gain.

If the payment increases or creates a gain, that gain may be subject to nonrecognition under the general sale of a residence rules found in IRC §121, assuming the taxpayer qualified for the exclusion at the time of the foreclosure.

If borrower is deceased and payment made to the estate or heir, the payment recipient "steps in the shoes" of the borrower for purposes of determining the tax treatment of the payment.

Section: 1001
Taxpayer's Basis in Stock Sold Reduced By Compromised Balance of Debt

Citation: Moore v. Commissioner, TC Memo 2013-249, 10/31/13

A taxpayer's basis in stock he sold was the issue the Tax Court had to decide in the case of Moore v. Commissioner, TC Memo 2013-249, http://www.ustaxcourt.gov/InOpHistoric/MooreMemo.Thornton.TCM.WPD.pdf.

The difference in the IRS's and taxpayer's view of his basis in his stock was certainly significant. The taxpayer claimed a loss of $1,502,519, while the IRS claimed he actually had a gain of $2 million. The issue revolved around Mr. Moore's purchase agreement for the shares, the arrangement used to finance those shares and litigation Mr. Moore engaged in related to that arrangement.

Mr. Moore had agreed to purchase shares of stock from a departing shareholder at the encouragement of the corporation. The corporation wanted to insure that the shares stayed in "friendly" hands. The corporation agreed to advance Mr. Moore the funds, via a loan, to buy the shares from the third party.

Mr. Moore executed the agreement and acquired the shares. As payments came due the corporation provided the funds for the payment and charged the balance to Mr. Moore's loan account, which also provided for interest.

Mr. Moore came to the conclusion that the corporation had mislead him with regard to the value of the shares he had agreed to purchase from the departing shareholder. He brought a lawsuit against the corporation with regard to the loan, arguing that due to the misrepresentation he should not be held liable to pay the entire balance. Eventually the dispute was settled and the corporation reduced the balance due by over $4,300,000.

The taxpayer claimed as basis when he sold stock the amounts under the original purchase agreement, arguing that the transaction was separate from the dispute with the corporation over the loan. The IRS argued that the two transactions were so deeply intertwined that Mr. Moore's basis in the stock should be reduced to the amount that he actually repaid (net of interest).

The Court accepted the IRS's argument, noting:

> The economic reality of the transactions in question, viewed in their totality, was that Mr. Moore agreed to purchase Mr. Baker's ATS shares as an accommodation to ATS, with an understanding that ATS' funds would be used to pay the nominal purchase price. According to Mr. Moore's own allegations in his subsequent lawsuit against ATS, there was no expectation that he should pay out of his own funds more than the true economic value of the shares, which both he and ATS ultimately agreed was only $1 million.

The court noted that, in fact, the corporation (ATS) paid the prior shareholder directly and Mr. Moore had no opportunity to use the funds for any other purpose. Thus, rather than two transactions the situation is properly viewed as a single transaction and Mr. Moore's basis is limited to what he actually paid.

The taxpayer also, somewhat questionably, argued that the IRS examination of their return for the year in which the debt balance was written off supported their position as the IRS agreed there was no cancellation of indebtedness. The Court observes:

> The determination that petitioners had no cancellation of indebtedness income for 2002 is consistent with our view that Mr. Moore's original debt to ATS was not absolute and that the actual amount of the debt was the $1 million ultimately reflected in the agreed judgment.

To hold otherwise would have given Mr. Moore an unwarranted tax benefit—basis that was derived from a debt he never paid, and no income from the failure to repay that debt.

The taxpayer, despite being a CPA, did not have penalties imposed. The taxpayer had relied on advice from a national accounting firm and the court found that his reliance was reasonable and that he had provided the professional with all necessary information.

Section: 1014
Heirs Not Allowed to Challenge Basis in Property Subject to Special Use Valuation Under §2032A

Citation: Van Alen v. Commissioner, TC Memo 2013-235, 10/21/13

Taxpayers were denied in their attempt to argue that they should not be bound by an absurdly low value contained on an estate tax return whey they later sold the property in the case of *Van Alen v. Commissioner*, TC Memo 2013-235, http://www.ustaxcourt.gov/InOpHistoric/vanalenMemo.Holmes.TCM.WPD.pdf.

The taxpayers in question were beneficiaries of a trust that had received ranchland from their father when he passed away in 1994. An initial appraisal of the property had valued the ranchland at $1.963 million. However, on the estate tax return the value reported was $427,500, and a §2032A election was made with the value now set at $144,823.

The taxpayers were ages 18 and 14 when their father passed away. Shana, as an adult, signed the §2032A statement on her own, but Bret had the form signed by his mother, acting as guardian *ad litem* and as Trustee of the Trust to which the property passed.

The IRS examined the estate return, but this resulted eventually in a further reduction of the ranch value to $98,735.

In 2007, over ten years later, a conservation easement was sold on the property. The Trust's share of the sales proceeds were $910,000. The prepared K-1s reporting over $300,000 of capital gain distributed to each of the heirs. Neither heir reported any gains on their returns and, not surprising, the omission drew the IRS's attention.

The heirs claimed the original value was grossly understated. They had contacted the gentleman who prepared the original valuation, and he agreed the property was worth far more than shown on the Form 706.

The taxpayer argued, relying on Revenue Ruling 54-97, that they should not be bound by a clearly erroneous valuation on the estate tax return. That ruling provides that:

> Except where the taxpayer is estopped by his previous actions or statements, such value [reported on the estate tax return] is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence.

They argued they had such clear and convincing evidence.

The Tax Court decided that it didn't matter if they had such evidence. First, the Court pointed out that the provision above dealt with a predecessor to current IRC §1014(a)(1)—but since the special use valuation election had been made, the tax basis was governed instead by IRC §1041(a)(3) which provides that the special use valuation, rather than fair market value, is the basis to be used. Thus the Court argued that the statute bound the heirs to the value claimed for the special use valuation.

Second, the Tax Court found the duty of consistency bound the taxpayers in this case. The Court noted that to be bound by the duty of consistency, three facts had to be shown:

- A representation or report by the taxpayer;
- Reliance by the Commissioner; and
- An attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner.

The Court found that the real issue here was the first question, since the last two tests were pretty clearly satisfied by the facts.

The taxpayers argued that it wasn't they who made the initial representation, but rather it was the estate's executor. But the Court notes that the parties signed a consent to the §2032A special use valuation.

The fact that Brett had not signed, but rather had been represented by his mother, did not change the result. Brett did not allege that this mother had violated her fiduciary duty or acted negligently in agreeing to the special use valuation.

As the Court noted, both heirs benefitted significantly from the valuation. Even with the valuation the estate did not sufficient cash to pay the estate tax due. Had the higher value been used, the Court found it likely that most of the additional tax would have been taken from the interest left to the taxpayers and that a portion of the land likely would have needed to be sold to make the payment.

Thus they were precluded from arguing for the higher basis numbers.

Section: 1031
Despite Being An Attorney, Taxpayer's Son Still Could Not Be a Qualified Intermediary for His §1031 Exchange

Citation: Blangiardo v. Commissioner, TC Memo 2014-110, 6/9/14

The taxpayer in the case of *Blangiardo v. Commissioner*, TC Memo 2014-110, http://www.ustaxcourt.gov/InOpHistoric/BlangiardoMemo.Jacobs.TCM.WPD.pdf, entered into a contract for the sale of land, obtained the services of an attorney as an intermediary and reinvested the entire proceeds in replacement property in a timely fashion.

Which was all fine except for one not so minor problem—the attorney who served as the “qualified” intermediary was the taxpayer’s son. Under Reg. §1.1031(k)-1(k)(3) a family member, as defined in IRC §267(b), is barred from serving as a qualified intermediary.

As the Court noted:

> Petitioner also acknowledges that the intermediary used in the transaction was his son. However, petitioner asserts that he meets the requirements of the regulation’s safe harbor because (1) his son is an attorney; (2) the funds from property A were held in an attorney trust account; and (3) the real estate documents refer to the transaction as a section 1031 exchange. We do not accept petitioner’s argument. The regulation is explicit: A lineal descendant is a disqualified person, and the regulation makes no exception based on his/her profession.

Advisers must remember that it’s not just family members who are disqualified persons to function as intermediaries for §1031 exchanges. That category includes anyone who was an agent of the taxpayer. That includes “a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties…” [Reg. §1.1031(k)-1(k)(2)]

Section: 1035
Beneficiary Who Inherited Nonqualified Annuities Allowed to Enter Into §1035 Exchange

Citation: PLR 201330016, 7/26/13

In PLR 201330016 (http://www.irs.gov/pub/irs-wd/1330016.pdf) the IRS allowed a beneficiary who had inherited non-qualified annuities to exchange her annuity contracts under §1035 for new contracts. However, there were certain conditions the exchange met to be considered qualified.

The taxpayer had inherited four nonqualified annuity contracts on her mother’s death. Consistent with the requirements of IRC §72(s)(2)(B) the taxpayer had elected to take distributions from the contracts in accordance with her life expectancy.

Some time later the taxpayer decided that she would prefer to have the funds in other annuities that she thought would produce a higher rate of return. She asked the IRS to approve a §1035 tax free exchange of the annuities even though she was an inherited owner and not the original holder of the annuity.

The IRS noted that they agreed this was allowable, so long as the new contracts and distribution forms executed at the same time provided the payment system under §72(s)(2)(B) would be continued under the new policies.

Thus, so long as the taxpayer complies with the requirements for a proper exchange (most importantly having the annuities transferred directly to the new carrier) and the documents executed at the time of the exchange provide for a continuing of the payout of the new annuities “at least as quickly” as the old, a change can be made.

Section: 1091
IRS to Ignore Wash Sale Rules for Losses that May Be Triggered on Sale of Money Market Funds Following SEC Rule Change

Citation: Revenue Procedure 2014-45, 7/23/14

The Securities and Exchange Commission is considering modifications to rules governing money market funds so that some such funds would not longer be required to maintain a stable share price (that is, they would be allowed to "break the buck"). In anticipation of the release of these rules the IRS released Notice 2013-48 (http://http.irs.gov/pub/irs-drop/n-13-48.pdf) that contains a proposed Revenue Procedure that will create a exception from §1091's wash sale rules for losses that may arise from such funds in limited cases.

The proposed Revenue Procedure would not go into effect until and unless the SEC finalizes its proposed regulations in the form that would allow "breaking the buck" for these funds. For those funds, the Revenue Procedure that the wash sale rules would not apply to a loss on the sale of such money market funds so long as the loss is not more than ½ of 1% of the taxpayer's basis in the shares.

Following the issuance of that proposed rule indicating that it would not really reduce the burdens associated with frequent money market sales and the wash sale rule, since the taxpayer would need to track potential loss sales just to insure the ½ of 1% rule wasn't violated. Commentators noted that money market funds that are designed to have a stable share price really are not the type of vehicle that IRC §1091 (the wash sale rule) was meant to address.

Based on these comments, the IRS issued Revenue Procedure 2014-45 (http://www.irs.gov/pub/irs-drop/rp-14-45.pdf) where it states that it will modify the regulations so that sales of these money market funds will be exempted from the wash sale rules. At the same time the IRS issued proposed regulations to implement these rules (REG-107012-14, http://www.treasury.gov/resource-center/tax-policy/Documents/MMF%20Acc't'g%20NPRM.pdf).

Section: 1092
Final Regulations Issued to Describe When Taxpayer's Own Debt May Be Considered Part of a §1092 Straddle Transaction

Citation: TD 9691, 8/27/14

In September of 2013 the IRS issued final, temporary and proposed regulations (TD 9635, http://www.gpo.gov/fdsys/pkg/FR-2013-09-03/pdf/2013-21330.pdf) that expand the definition of property that may be part of a straddle to include a taxpayer's own debt if payment on the debt is linked to the value of other personal property.

The proposed regulations were made final in TD 9691, http://www.gpo.gov/fdsys/pkg/FR-2014-08-27/pdf/2014-20330.pdf replacing the 2013 temporary regulations.

No comments were received on the proposed regulations and they were adopted with few changes in the final regulations. The most significant changes were to clarify effective dates of the regulations to certain detailed provisions—but these dates generally go back to 2001.

For instance, if a taxpayer entered into a debt obligation where the interest to be paid was linked to any increase in a specified stock index, the debt could effectively become part of a straddle if the taxpayer held an offsetting position based on that same index. By being "linked" as part of the straddle, the deduction for interest would be deferred until the gain on the offsetting position was recognized.

These regulations had previously existed only as proposed regulations, though with a retroactive effective date back to 2001. These regulations retain that effective date.

Section: 1092
IRS Modifies Treatment of Positions That Later Become Part of Straddle-By-Straddle Election under §1092(b)(2)

Citation: TD 9627, 8/2/13

The IRS modified the treatment of existing unrealized gain/loss on a position that later becomes a position in an identified mixed straddle under §1092(b)(2) in Treasury Decision 9627 (http://www.ofr.gov/OFRUpload/OFRData/2013-18702_PI.pdf) , establishing Temporary Regulation 1.1092-6T. Proposed regulations with identical language were issued at the same time.

Under prior regulations a taxpayer would immediately recognize any pre-existing unrealized gain/loss in the position as of the day before the position become part of an identified mixed straddle. The IRS announced that it "has come to the attention of the Treasury Department and the IRS that this paragraph arguably permits taxpayers to selectively recognize gains and losses in inappropriate circumstances and without market constraints."

While admitting the prior treatment seemed more consistent with the legislative history, the IRS has decided that the pre-existing gain/loss will not be recognized until the time that the gain/loss would have been recognized had the mixed-straddle election under §1092(b)(2) not been made. The character of the pre-existing gain/loss will also be determined as if the election had not been made.

The proposed regulations apply to identified mixed straddles established after August 1, 2013.

Section: 1221
Position in Lawsuit Was Capital Asset and Payment for That Right Was Not Substitute for Ordinary Income

Citation: Long v. Commissioner, 114 AFTR 2d ¶ 2014-5446, CA 11, 11/20/14 reversing TC Memo 2013-233, 10/21/13

The issue was not whether Phillip Long had income. Rather the question was the nature of that income. The Tax Court, in its ruling in this case, found that Phillip's income was ordinary in nature (TC Memo 2013-233).

However, the Eleventh Circuit reversed that ruling (*Long v. Commissioner*, 114 AFTR 2d ¶ 2014-5446, finding the income was capital in nature.

The income in question arose from an assignment agreement of $5.75 million Mr. Long received as a payment for his position in a lawsuit that arose from his attempts to acquire land on which condominiums would be built.

Although the entire history of the transactions is more than a bit convoluted, the basic issues that the Eleventh Circuit looked at involved this part of Mr. Long's past:

> In 2002, Long, negotiating on behalf of LOTC, entered into an agreement with LORH (the Riverside Agreement) whereby LOTC agreed to buy land owned by LORH for $8,282,800, with a set closing date of December 31, 2004. LORH subsequently terminated the contract unilaterally and, on March 26, 2004, LOTC filed suit in Florida state court against LORH for specific performance of the contract and other damages. LOTC won at trial, and on November 21, 2005, the state court entered judgment in favor of LOTC, and ordered LORH to honor the Riverside Agreement and proceed with the sale

> of the land to LOTC within 326 days from the date of entry of the final judgment. LORH appealed the judgment.
>
> In August 2006, during the appeals process for the Riverside Agreement litigation, Steelervest and Long renegotiated the terms of the AJV Agreement, and, in a new agreement (the Amended AJV Agreement), Long agreed to pay Steelervest fifty percent of the first $1.75 million, up to a maximum of $875,000, of monies received by Long as a result of the Riverside Agreement litigation. On September 13, 2006, Long entered into an agreement with Louis Ferris, Jr. (the Assignment Agreement), whereby Long sold his position as plaintiff in the Riverside Agreement lawsuit to Ferris for $5,750,000. While the Amended AJV Agreement arguably entitled Steelervest to $875,000, Steelervest agreed to receive $600,000 and release all rights to pursue collection under the Amended AJV Agreement.

The Tax Court had concluded that Mr. Long had intended to develop the land in question and that, therefore, the payments in question for his rights in the lawsuit constituted ordinary income.

The Eleventh Circuit panel disagreed. The opinion notes:

> The Tax Court erred by misconstruing the "property" subject to capital gains analysis under §1221. The Tax Court analyzed the capital gains issue as if the land subject to the Riverside Agreement was the "property" that Long disposed of for in return for $5.75 million. The record makes clear, however, that Long never actually owned the land, and, instead, sold a judgment giving the exclusive right to purchase LORH's land pursuant to the terms of the Riverside Agreement. In other words, Long did not sell the land itself, but rather his right to purchase the land, which is a distinct contractual right that may be a capital asset. See *Pounds*, 372 F.2d at 346. The Tax Court erred by ignoring this distinction.

Determining that the judgment was the property in question, the Eleventh Circuit found that it no longer made sense to use a "substitute for ordinary income" treatment. The panel held:

> There is no evidence that Long entered into the Riverside Agreement with the intent to assign his contractual rights in the ordinary course of business, nor is there evidence that, in the ordinary course of his business, Long obtained the Florida court judgment for the purpose of assigning his position as plaintiff to a third party. Rather, the record makes clear that Long always intended to fulfill the terms of the Riverside Agreement and develop the Las Olas Tower project himself.
>
> … It cannot be said that the profit Long received from selling the right to attempt to finish developing a large residential project that was far from complete was a substitute for what he would have received had he completed the project himself. Long did not have a future right to income that he already earned. By selling his position in the litigation, Long effectively sold Ferris his right to finish the project and earn the income that Long had hoped to earn when he started the project years prior. Taxing the sale of a right to create and thereby profit at the highest rate would discourage many transfers of property that are beneficial to economic development.

The panel also refused to sustain the IRS's secondary argument that if the asset was capital, it was short term in nature since the original court decision was less than a year earlier. The Court refused to follow this logic, noting that instead, at worst, the right was created when suit was filed more than a year earlier. As well, the actual rights that eventually gave rise to the lawsuit went back another two years.

Section: 1221
No Capital Gain Treatment for Reward Received under False Claims Act Since There Was No Sale or Exchange of a Capital Asset

Citation: Patrick v. Commissioner, 142 TC No. 5, 2/24/14

Taxpayers were again beaten back in an attempt to broadly define a "capital asset" and a "sale of a capital asset" in order to gain access to the preferential capital gain tax rates in the case of Patrick v. Commissioner, 142 TC No. 5, http://www.ustaxcourt.gov/InOpHistoric/PatrickDiv.Kroupa.TC.WPD.pdf.

In this case the taxpayers were looking to get capital gain treatment for an amount they received as a reward for, effectively, turning in the husband's employer through a *qui tam* complaint filed under the False Claims Act.

The taxpayer had worked for an entity which, in the taxpayer's view, had acted illegally to indirectly create excessive Medicare billings for the customers of its equipment. The company had created equipment which, due to being minimally invasive, allowed certain medical procedures to be performed on an outpatient basis. However being an outpatient procedure the company worried that some potential customers would refuse to purchase the equipment due to that effect.

Thus the company instructed its salesforce to market the procedure using the equipment as being an inpatient procedure. Some providers, following this advice, billed such expenses to Medicare.

The taxpayer brought an action on behalf of the government under the False Claims Act (a *qui tam* procedure) making use of information the employee had. Under the law a whistleblower taking this approach is awarded a portion of any resulting amount eventually received by the government. The taxpayer received over $6 million in funds under this program.

On his tax return, the whistleblower claimed the payment represented a capital gain taxed at the lower capital gain rates. The IRS and the Tax Court disagreed, arguing that such income failed to meet key requirements necessary to obtain capital gain treatment.

The taxpayers argued that they had sold information to the government in exchange for a share of the settlement, a transaction they viewed as being the sale of a capital asset. The Court found both that there was no sale and that the taxpayer had no capital asset which could have been sold.

First, the court found that under the FCA the whistleblower was obligated to provide all supporting information to the government in order to be eligible to share in the award. The taxpayer argued that the FCA created a contractual right (which would be a capital asset). However, the Court found that the FCA created no contractual rights, but rather simply permits a person to advance a claim on behalf of the government and then receive a reward for doing so.

The Court distinguished this situation from the sale of a trade secret, something the taxpayers argued the case was analogous to. In the case of the sale of a trade secret the transferor transfer all substantial rights to the government—but the taxpayer transferred no rights to the government.

The taxpayer's argument that the asset in question was a right to future income ran afoul of the ordinary income doctrine (a doctrine also used against attempting to get capital gain treatment for the proceeds from the sale of a winning lottery ticket). Generally a capital asset does not include property that itself represents an item of income, nor any increase in the value of a capital asset that is itself attributable to income.

Finally the Court agreed with the IRS that the information and documents themselves were not property of the taxpayer, since the taxpayer had no right to exclude others from the use of the items in question. The taxpayer had an obligation under the FCA to disclose the information to the government and had no right to prevent either his employer or the medical service providers involved from using or disclosing the information.

So what the taxpayer had was simply ordinary income and it was to be taxed as such.

Section: 1234A
Abandonment of Securities Generates a Capital and Not Ordinary Loss Due to Application of §1234A

Citation: Pilgrim's Pride Corporation v. Commissioner, 141 TC No. 17, 12/11/13

Apparently the taxpayer and the IRS didn't understand the real issue, but the Tax Court sent them back to look at the issue in a different way, resulting in a rather significant decision in the case of *Pilgrim's Pride Corporation v. Commissioner*, 141 TC No. 17, http://ustaxcourt.gov/InOpHistoric/Pilgrim%27sPrideDiv.Dawson.TC.WPD.pdf. The case ended up turning on the issue of whether it is possible for a taxpayer to achieve an ordinary loss when abandoning a security under the current version of IRC §1234A.

The corporation in this case had abandoned securities which had a basis of $96.8 million rather than accept an offer to redeem them of $20 million. The corporation believed an abandonment would generate an ordinary loss under IRC §165, and that the tax benefit from the ordinary loss would exceed the $20 million being offered for a sale of the shares.

Generally IRC §1211 governs capital gain or loss status, and it does not apply if there is not a sale or exchange. Without a sale or exchange, a loss generally would be treated as an ordinary loss under the general rule of IRC §165.

However, IRC §1234A provides the following:

> **Code Sec. 1234A.** Gains or losses from certain terminations
>
> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of -
>
> > (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
> >
> > (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,
>
> shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).

Neither the IRS nor the corporation had originally argued that this provision would apply to a purported abandonment of stock—but the Tax Court believed it might be the key and asked the parties to submit arguments on the issue.

The taxpayer argued that the provision clear was meant to address not property already held, but rather rights held by the taxpayer. The taxpayer suggested that the provision was not meant by Congress to effectively eliminate the ability to abandon a security or similar ownership interest that gave the holder certain rights with the regard to the entity in question.

The Tax Court did not agree. The Court held:

> We hold that the plain meaning of the phrase "a right or obligation * * * with respect to property" encompasses the property rights inherent in intangible property as well as ancillary or derivative contractual rights.

The taxpayer protested that if this reading of the statute were correct, the IRS should have revised Revenue Ruling 93-80. That ruling dealt with issue of an abandonment vs. a sale of a partnership interest.

As the Court described it, the ruling in question held:

> In situation 1 there was a deemed distribution to the partner resulting from the reduction in his share of partnership liabilities. The ruling held that the loss on the abandonment was a capital loss. In situation 2, the partner was not entitled to include any portion of partnership liabilities in the basis of his partnership interest and did not receive any actual or deemed distributions when he abandoned his partnership interest. The ruling held that the loss in situation 2 was an ordinary loss. The ruling holds that a loss incurred on the abandonment or worthlessness of a partnership interest is an ordinary loss only if sale or exchange treatment does not apply. The ruling makes clear that, if a provision of the Code requires the transaction to be treated as a sale or exchange, such as when there is a deemed distribution attributable to the reduction in the partner's share of partnership liabilities pursuant to section 752(b), the partner's loss is capital.

If §1234A applies to the stock interest, it certainly would appear it would apply to the partnership interest, and therefore the loss in situation 2 would be capital in nature, just like the loss in situation 1. The taxpayer argued that since the IRS had not revised this ruling, clearly the IRS must believe that §1234A is inapplicable to an ownership interest.

The Tax Court did not agree. The opinion notes:

> Rev. Rul. 93-80, supra, was issued four years before section 1234A was amended in 1997 to apply to all property that is (or would be if acquired) a capital asset in the hands of the taxpayer. As we previously stated, the Commissioner is not required to assert a particular position as soon as the statute authorizes such an interpretation, whether that position is taken in a regulation or in a revenue ruling.

Thus the Court concludes:

> The surrender of the Securities terminated all of GK Co-op's rights with respect to the Securities which were capital assets in the hands of GK Co-op. The loss on the surrender of the Securities is attributable to the termination of those rights. Accordingly, the loss is treated as a loss from the sale of a capital asset pursuant to section 1234A.

As the taxpayer noted, this view of §1234A has broad implications, and not just for the sale of stock. The Tax Court implicitly agreed with the view that it should be similarly impossible for a taxpayer to obtain ordinary loss treatment on the sale of a partnership interest.

Section: 1235
Capital Gain Treatment Denied for Patent Income Where Patent Transferred to Corporation Taxpayer Informally Controlled

Citation: Cooper v. Commissioner, 143 TC No. 10, 9/23/14

A taxpayer's retention of effective control of a corporation to which he sold a patent resulted in the income from the patent being treated as ordinary income and not capital gain in the case of *Cooper v. Commissioner,* 143 TC No. 10.

The issue involved IRC §1235(a) which provides:

> A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year, regardless of whether or not payments in consideration of such transfer are -
>
> > (1) payable periodically over a period generally coterminous with the transferee's use of the patent, or
> >
> > (2) contingent on the productivity, use, or disposition of the property transferred.

Such transfers do not confer capital gain treatment if transferred to a related party which would include an entity in which Mr. Cooper held a 25% or greater interest. [IRC §1235(d)] Counsel advised Mr. Cooper that he could not control the corporation to which he would sell the patent either directly or indirectly and his ownership interest had to be less than 25%

In this case Mr. Cooper transferred a patent to a corporation in which he held a 24% interest. Remaining interests in the entity were held equally by Mr. Cooper's sister and a long-time friend.

However, the Tax Court found that, despite technically having no direct control, he had effective control. The Court noted:

> Here, Mr. Cooper -- troubled by his deteriorated business relationship with Mr. Leckrone -- formed TLC with individuals he could trust and ultimately control. Ms. Coulter and Ms. Walters -- the shareholders and directors of TLC (along with Ms. Cooper) -- did not have the patent, engineering, or other such skills to make them particularly valuable to a small patent licensing company. Instead, they were individuals whom Mr. Cooper could trust to follow his direction on patent licensing issues. Indeed, Ms. Coulter testified that the technical negotiations regarding licensing and patent infringement were over her head and she deferred to Mr. Cooper on such issues. She further testified that she signed licensing and infringement agreements when directed to do so by TLC's attorneys and signed checks and transferred funds when directed to do so by TLC's accountants.
>
> As officers and directors of TLC, Ms. Coulter and Ms. Walters took numerous actions that are inconsistent with acting independently and in the best interest of the corporation. Among other things, Ms. Coulter and Ms. Walters approved TLC's transfer of potentially valuable patents to Mr. Cooper for no consideration. At least in one instance, Mr. Cooper almost immediately licensed one of these patents to another related corporation for which that corporation received a royalty of $120,000 in 2007. As shareholders Ms. Coulter and Ms. Walters signed a stock restriction agreement placing restrictions on their ability to transfer shares of stock in TLC to anyone other than petitioners, without receiving any consideration in exchange. The stock restriction agreement did not place similar restrictions on petitioners.

> Indeed, it is unclear what material decisions, if any, the officers and directors of TLC made independent of Mr. Cooper. Mr. Cooper -- and not the officers or directors of TLC -- provided technical assistance to the Niro firm in interpreting the subject patents and relevant technology and in formulating patent enforcement strategies. Mr. Cooper conducted all technical matters for TLC -- which in substance was all or a large part of TLC's activities. Furthermore, in his role as general manager of TLC and under the terms of the letter agreement, Mr. Cooper made all material decisions for TLC with respect to the IP Innovation assignment agreement and the New Medium and AV Technologies agreements.

Thus, by retaining effective control of the corporation, the taxpayer had not transferred "all substantial rights to a patent" to an unrelated third party, making the income he received taxable as ordinary income.

This case illustrates the issues that can arise when advisers attempt to use mechanical structures to obtain a tax benefit, but assure the taxpayer that "really" nothing had changed. In this case the Court worked to find a rationale to deny a tax benefit that just, at least in the view of the Court, didn't "smell" right and appeared at odds with Congress's goal in enacting the provision.

Unfortunately, at times the law does have purely mechanical tests which the Court will apply even if the result appears "too good to be true." But a key difference, most often, is that it appears that Congress intended to provide for the result in question. If that is not the case, the Court may (as it did here) look for provisions (in this case whether a real transfer took place) to make the mechanical compliance in other areas irrelevant.

The key problems in this case revolve around the fact that, in operation, the taxpayer retained full decision making power with regard to the patent and, based on the restrictions on transferability of the stock imposed on the other two shareholders (but not on Mr. Cooper), Mr. Cooper effectively insured his continued control over the patent in question. So the transaction simply failed the "smell" test.

Section: 1402
Factors for Use in Optional Methods for Computing Self-Employment Income Revised for 2015

Citation: Social Security News Release, 10/23/14

The Social Security Administration, in a fact sheet, has announced an increase in the amount that will be required for an employee to obtain a quarter of coverage for social security to $1,220 per quarter.

This will change the various factors used in the computation of the various optional methods for computing self-employment earnings under §1402.

The lower limit for computing the optional methods will be $4,880 and the upper limit will be $7,320 for 2015.

An individual qualifies for the optional nonfarm method only if he/she meets the following conditions:

- The individual had net nonfarm profits of less than $5,284;
- The net nonfarm profits were less than 72.189% of the individual's gross nonfarm income; and
- The individual had earnings from self-employment of at least $400 in each of the prior three years

Taxpayers computing their self-employment earnings under the optional non-farm method for 2015 will compute their earnings as the smaller of two thirds of gross nonfarm income or $4,880 for 2015.

Taxpayers qualify to use the farmer's optional method if he/she meets the following criteria:

- The individual's gross farm income was not more than $7,320 or
- The individual's net farm profits are less than $5,284

For the farmer's optional method, the amounts will be the lesser of two-thirds of gross farm income or $4,880 for 2015.

If a taxpayer uses both optional methods, the total earnings from self-employment may not exceed $4,880 for 2015.

Section: 1402
Eighth Circuit Overturns Tax Court Rulng that CRP Payments Were Self-Employment Income When Paid to a Non-Farmer

Citation: Morehouse v. Commissioner, 14 TC No. 16, 6/18/13, reversed CA8, 114 AFTR 2d ¶ 2014-5340, 10/10/14

An IRS Tax Court victory in the case of *Morehouse v. Commissioner*, (original decision at 14 TC No. 16), was overturned on appeal in a split decisions by a panel of the Eighth Circuit in Case No. 13-3110, 114 AFTR 2d ¶ 2014-5340.

The case in question involved whether payments received under the U.S. Department of Agriculture's Conservation Reserve Program (CRP) represented income subject to the self-employment tax.

Mr. Morehouse owned farmland in South Dakota, though he resided in Minnesota. He had been renting out the farmland to tenants for a number of years to farm, but he decided in 1997 to participate in the program described above. In that program the taxpayer would be paid by the government to keep the land out of production and to follow a conservation plan.

He reported such income as exempt rental income under IRC §1402(a) arguing either that a) such payments represented income not from the active conduct of a trade or business or b) that the payments represented payments for rental of real estate exempt under IRC §1402(a)(1).

The Tax Court noted that IRC §1402(a)(1), while generally exempting rental real estate from the definition of self-employment income, the provision "shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity…"

As well, generally §1402 applies self-employment tax to net income "trade or business carried on by such individual" so both tests will look at Mr. Morehouse's activity with regard to the business. The court noted, in describing this test that first we look for the existence of a trade or business, noting that "to be engaged in a trade or business with respect to which deductions are allowable under section 162, the taxpayer must be involved in the activity with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit."

So the question becomes is whether Mr. Morehouse's involvement was sufficient to meet the general test for a trade or business and the special rule for farm rentals.

Mr. Morehouse entered into a contract with the government and agreed that certain actions would take place, including the planting of certain plants and other maintenance on the property. While Mr. Morehouse entered into the contract each year and would visit from time to time to inspect the property, most of the actual work was done by Mr. Redlin, a person he contracted with to perform such services.

The Tax Court found the proper test was to look at the services performed both by Mr. Morehouse and his agent, Mr. Redlin, to determine if there was a trade or business. The court noted that "[r]egardless of whether some or all of these activities qualify as farming, we find that petitioner was engaged in the business of participating in the CRP and that he enrolled, maintained, and managed multiple properties subject to CRP contracts with the primary intent of making a profit."

On the rental question, the Tax Court noted that the IRS had taken the position in Notice 2006-108 that CRP payments should be subject to self-employment tax. The Sixth Circuit, in the case of *Wuebker v. Commissioner* held that CRP payments are not exempted under the rental real estate classification, even though the Department of Agriculture labels the payments as rents. The Tax Court went on to note that following this case Congress passed provisions exempting CRP payments from self-employment tax if paid to individuals receiving Social Security or disability payments—indicating Congress did not intend to remove all such payments from taxation as self-employment income.

Thus, the Tax Court found that Mr. Morehouse was subject to self-employment tax on the payments.

A majority of the Eighth Circuit panel, however, rejected that view. The Court found that the facts in *Wuebker* were significantly different from those in this case. The majority found the Sixth Circuit's reasoning "not abundantly clear" but determined that case turned on the fact that the acts the taxpayer performed in that case for the CRP payment were intrinsically similar to those performed in their active farming operation, leading the Sixth Circuit to conclude the payments were not rental activities. The obligations did not rise to the level of "occupancy or use" by the government.

However, the majority noted, the Eighth Circuit did not comment on or reject the view, outlined in Revenue Ruling 60-32, that such payments to non-farmers did not represent self-employment income.

The panel comments on Notice 2006-108, cited above, that contained a proposed revenue ruling that, if adopted, would obsolete Revenue Ruling 60-32. The Court notes that the IRS has not gone ahead and actually formalized that proposed ruling, concluding the IRS now had "doubts" about extending the *Wuebeker* holding this far.

Thus, the majority held the IRS to the position stated in Revenue Ruling 60-32 and reversed the Tax Court.

However, Judge Gruender in his dissent points out an issue that the Court seemed to glance over—are these payments rents? *Wuebeker* found that the payments failed to meet the definition of rents, since the federal government neither occupied nor used the property in question. If the payments are not rental payments, then the exclusion does not apply and the only real question becomes the "active conduct of a business" issue—which was an issue the majority did not deal with.

The dissent eventually decides that Notice 2006-108 should not be totally ignored, as the majority did, but agrees that the IRS's inconsistent position limits its influence. However the dissent goes on to simply decide that even if no deference is granted, the payments simply aren't rent.

A single circuit's split decision to overturn a Tax Court decision is a unique situation that complicates the practical problem of dealing with this issue outside of the Eighth Circuit. Technically the decision only is binding in the Eighth Circuit. The Tax Court, who felt they were responding to the demands of another Circuit in the original decision, will likely continue to treat such payments as self-employment income outside of the Eighth Circuit and it seems likely the IRS will as well.

Advisers with non-farmers who are in receipt of such payments will need to discuss the implications of this issue with their clients and decide what steps may make sense both in taking original return positions and/or considering filing claims for refund for previously paid self-employment tax.

Section: 1402
Wife Actually Ran Real Estate Business, All Self-Employment Income Allocable to Her

Citation: Fitch v. Commissioner, TC Memo 2013-244, 10/29/13

The taxpayers argued that both husband and wife jointly operated a real estate business. As such, under Reg. §1.1402(a)-8(a) the taxpayers argued that all self-employment income must be allocated to the husband from the business. [Fitch v. Commissioner, TC Memo 2013-244, http://www.ustaxcourt.gov/InOpHistoric/FitchMemo.Vasquez.TCM.WPD.pdf]

That regulation has what some term a "sexist" view of the situation, providing:

> (a)In case of an individual.—If any of the income derived by an individual from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income, and the deductions attributable to such income, shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife. For the purpose of this special rule, the term "management and control" means management and control in fact, not the management and control imputed to the husband under the community property laws. For example, a wife who operates a beauty parlor without any appreciable collaboration on the part of her husband will be considered as having substantially all of the management and control of such business despite the provision of any community property law vesting in the husband the right of management and control of community property; and the income and deductions attributable to the operation of such beauty parlor will be considered the income and deductions of the wife

In this case the couple had two businesses in California. Mr. Fitch had a CPA practice which ran losses each year. Mrs. Fitch was a licensed real estate agent and, the couple argued, they both were involved in the real estate business. That business produced income, but income which was less than the losses incurred in the CPA practice.

The taxpayers argued that the regulation cited above would treat the entire amount of income from the real estate business as Mr. Fitch's. That would allow an offset of the income with the CPA practice losses, eliminating any self-employment tax.

The Tax Court found it didn't need to decide if the reliance on that view of the matter held, as it held that the couple had produced no evidence that Mr. Fitch participated seriously in the real estate business. The Court noted that in an earlier trial (this matter arose from computing the tax under that decision) Mrs. Fitch as consistently referred to the business as "my" business. Mr. Fitch also, in his references, referred to the real estate business as her business.

The Court noted there was no persuasive evidence of Mr. Fitch's involvement in the real estate activity, finding instead that the record before it indicate that it truly Mrs. Fitch's business. Thus, the court found that even if it applied the standard advanced that a wife must do virtually everything related to management in a business or find it taxed to the husband, Mrs. Fitch would meet that standard.

Section: 3121
Social Security Wage Base and Other Related Items for 2015

Citation: Social Security Administration News Release, 10/22/14

The Social Security Administration announced in an October 22, 2014 news release that the maximum amount of earnings subject to Social Security tax in 2015 will increase from $117,000 that was taxable in 2014 to $118,500 for wages paid in 2015.

As well, the Medicare website notes that the Medicare Part B base premium for 2015 will be $104.90 per month, unchanged from 2014. However, for certain "high income" individuals the following rates will apply:

If your yearly income in 2013 (for what you pay in 2015) was			
File individual tax return	**File joint tax return**	**File married & separate tax return**	**You pay (in 2015)**
$85,000 or less	$170,000 or less	$85,000 or less	$104.90
above $85,000 up to $107,000	above $170,000 up to $214,000	Not applicable	$146.90
above $107,000 up to $160,000	above $214,000 up to $320,000	Not applicable	$209.80
above $160,000 up to $214,000	above $320,000 up to $428,000	above $85,000 and up to $129,000	$272.70
above $214,000	above $428,000	above $129,000	$335.70

Advisers may want to consider advising taxpayers who had 2013 adjusted gross income above the limits for their filing status in 2013 who will be paying Part B premiums in 2015 regarding the higher premiums they will be paying during 2015 due to that level of income.

Section: 3121
Domestic Worker Threshold Amounts Issued for 2015

Citation: Social Security Administration Website, 10/22/14

The Social Security Administration has provided on the Employment Coverage Threshold page on their website, information on the coverage threshold levels for domestic workers in 2015. The threshold will remain at the same level as it was for 2014 ($1,900) in 2015.

Section: 3121
Settlement Payment Related to Age Discrimination Claim Properly Treated as FICA Wages

Citation: Gerstenbluth v. Credit Suisse, Internal Revenue Service, 2013-2 USTC ¶50,494, 2013 TNT 167-11, 8/27/13 affirming DC NY, 2012-2 U.S.T.C. ¶50,612, 9/28/12

In the case of Gerstenbluth v. Credit Suisse, CA2, 2013-2 USTC ¶50,494, 2013 TNT 167-11 (http://www.ca2.uscourts.gov/decisions/isysquery/1b0598b7-008f-43c4-9099-70d024b2c9f2/3/doc/12-4125_opn.pdf#xml=http://www.ca2.uscourts.gov/decisions/isysquery/1b0598b7-008f-43c4-9099-70d024b2c9f2/3/hilite/) the taxpayer, who was in receipt of a legal settlement from Credit Suisse, objected to the treatment of that settlement by Credit Suisse and the IRS as FICA wages.

Mr. Gerstenbluth has lost his case at the District Court level, so he appealed the decision to the Second Circuit Court of Appeals. Mr. Gerstenbluth had been terminated by Credit Suisse and, following his termination, had filed a complaint with the United States Equal Employment Opportunity Commission claiming age discrimination.

Eventually Mr. Gerstenbluth and Credit Suisse entered into a settlement where Mr. Gerstenbluth agreed to withdraw his complaint in exchange for $250,000 “minus applicable taxes and deductions.” Credit Suisse withheld social security and Medicare taxes from the payment and reported the amount on Form W-2.

Mr. Gerstenbluth argued that the payment was not properly treated as wages. The appellate panel noted that any damages awarded to Mr. Gerstenbluth would have been governed by the Age Discrimination in Employment Act (ADEA), which provides for awards of front and back pay, prejudgment interest, costs and attorney’s fees.

The Court looked at the factors to indicate the nature of the payment. The Court noted that it must emphasize the payor’s intent in making the payment. The Court found that, even though treating it as FICA taxable may have been the “safest” treatment for Credit Suisse, the Court noted that the agreement specifically mentioned withholding of taxes.

The Court noted that Credit Suisse’s treatment, while presumptively correct, can be overcome if the recipient can show the treatment is not in line with the true economics. But the Court did not find that the taxpayer’s arguments persuasive.

The Court rejected the taxpayer’s argument that Publication 4345 requires the treatment as other than FICA first. First, the Court noted that IRS Publications are not binding, and cannot overturn what is settled law. Second, the Court found that merely because the Publication mentioned reporting settlements on Line 21 of Form 1040 rather than Line 7 (the wage line of Form 1040), that it meant that was a holding that the payments were not FICA wages.

The Court also did not agree the settlement had to be computed based on the amount of his wages that he would have earned.

Rather the Court found it was more reasonable to view this payment as compensation related to Mr. Gerstenbluth’s services and thus subject to FICA.

Section: 4973
IRS Could Still Assess Excess Contribution Excise Tax Even Though the Agency Failed to Challenge Original Income Tax Transaction

Citation: Mazzei v. Commissioner, TC Memo 2014-55, 4/1/14

In the case of *Mazzei v. Commissioner*, TC Memo 2014-55, http://www.ustaxcourt.gov/InOpHistoric/MazzeiMemo.Chiechi.TCM.WPD.pdf, the taxpayer discovered that an “old and cold” transaction for income tax purposes could still come back to haunt them for the purposes of other taxes.

The taxpayer had engaged in a variant of a “Roth IRA stuffer” transaction where a taxpayer established a Roth IRA and used assets of that Roth IRA to acquire a controlled entity. That entity (in this case a Foreign Sales Corporation) received payments from the taxpayer’s business (in this case a partnership) which were deductible to the business. This FSC then made dividend distributions to the Roth IRAs.

The net effect of this was to move income from the business to inside the IRA, effective creating a “deductible” IRA contribution. The taxpayers continued this practice for the years 1998-2001 until the FSC law was repealed, at which time the taxpayers ceased the practice. The Roth IRA stuffer transaction was finally named a listed transaction in IRS Notice 2004-8.

The IRS finally examined the taxpayers for 2005, with the exam taking place in 2007. At this time the IRS discovered the existence of the entity in the Roth IRA, as well as the stuffing transaction. The agent found, however, that no commissions had been paid to the IRA since 2001.

While the agent believed the commissions should have resulted in taxable income to the taxpayers, the years were closed for examination. Nevertheless, the IRS concluded that the taxpayers were subject to an excess contributions tax under IRC §4973(a). That tax runs at 6% per year on any excess contributions until the situation is corrected. And, of course, in the IRS's view the problem had not been corrected.

The taxpayer cried foul, noting that the IRS had not assessed the taxpayer under the income tax provisions for the years of the contribution. The taxpayer cited *Hellwig v. Commissioner*, TC 2011-58 http://www.ustaxcourt.gov/InOpHistoric/repettomemo.TCM.WPD.pdf and *Ohsman v. Commissioner*, TC Memo 2011-98, http://www.ustaxcourt.gov/InOpHistoric/Ohsman.TCM.WPD.pdf where the IRS had attempted to assess various excise taxes on similar transactions but had not challenged the income tax treatment.

The Tax Court indicated that the current situation was different. In the prior cases the IRS had taken an inconsistent position, finding the transactions were not a problem for income tax purposes but that they violated the excise tax rules. But in this case the IRS did not argue the transactions were valid for income tax purposes, rather asserting they were a problem for both income tax and excise tax purposes. However, the statute of limitations on assessments prevented the IRS from assessing tax on the income tax issue.

That is, the mere fact that the taxpayers were able to stay below the IRS radar until the statute had expired on any income tax assessment for the transactions did not mean that the transactions were now "blessed" for all other purposes.

Since the IRS had not taken an inconsistent position (they just arrived too late to collect all the tax they should have been able to collect), the Court found that it could look at the IRS argument that the transaction should be rejected on the substance over form argument. As such, those 1998-2001 payments constituted excess contributions to the taxpayer's Roth IRAs, and those funds remained in the Roth IRA in the years before the Court (2002-2007).

Section: 5000A
Final Regulations Issued for §5000A Individual Shared Responsibility Payments

Citation: TD 9705, 11/21/14

Final regulations have been issued by the IRS for IRC §5000A's individual shared responsibility payment (TD 9705).

The revisions in these regulations address issues related to employee contributions to cafeteria plans, HRAs and wellness program incentives.

For cafeteria plans, the preamble notes that "the final regulations provide that, for purposes of determining the affordability of coverage, the required contribution is reduced by any contributions made by an employer under a section 125 cafeteria plan that (1) may not be taken as a taxable benefit, (2) may be used to pay for minimum essential coverage, and (3) may be used only to pay for medical care within the meaning of section 213..." Such flex contributions reduce the employee's required contribution for the year.

Health reimbursement arrangements are also discussed in the final regulations. Amounts made available under an HRA are taken into account in determining an employee's or related individual's required contribution for health care if the HRA would have been integrated with the employer's plan (as described in Notice 2013-54) had the employee enrolled in the employer's plan.

Although an HRA may be integrated with another employer's plan under Notice 2013-54, in such a case the HRA amounts are not considered in determining an employee's required contribution.

HRA contributions count toward affordability, and not minimum value, if the HRA contributions may only be used to purchase the plan or pay for cost-sharing or other benefits not provided by the primary plan.

For wellness programs, the preamble notes:

> The proposed regulations provide that, in determining whether coverage under an eligible employer-sponsored plan is affordable for purposes of the affordability exemption in section 5000A(e)(1), nondiscriminatory wellness program incentives are treated as earned only if the incentives relate to tobacco use. For this purpose, a nondiscriminatory wellness program is a wellness program that does not violate the wellness plan regulations whether the program is participatory or outcome based. See §54.9802-1(f), 29 CFR 2590.702(f), and 45 CFR 146.121(f) for regulations governing wellness program incentives issued by the Departments of Labor and HHS, and the Treasury Department and the IRS (tri-agency regulations). The section 36B proposed regulations include an identical rule for counting wellness program incentives in determining an individual's required contribution.
>
> … The proposed regulations provide that the affordability of eligible employer-sponsored coverage is determined by assuming that each employee fails to satisfy the requirements of a wellness program, except the requirements of a nondiscriminatory wellness program related to tobacco use. Thus, the affordability of coverage that requires a higher initial premium for tobacco users is determined based on the premium that is charged to non-tobacco users or to tobacco users who complete the related wellness program, such as attending smoking cessation classes.

The final regulations retained these provisions.

The final regulations also provide that, in certain cases, an individual may claim a hardship exemption without having to receive a certificate issued by a Marketplace in situations described in guidance issued by HHS and IRS. Notice 2014-76 provides the initial list of such exemptions.

Section: 5000A
IRS Publishes List of Hardship Exemptions for Which a Specific Application to State Exchange Not Required

Citation: Notice 2014-76, 11/21/14

In Notice 2014-76 the IRS identified hardship exceptions that have been published to date by the Department of Health and Human Services to the requirement to obtain qualifying coverage under IRC §5000A. Individuals meeting the requirements for these hardship conditions will not need to obtain a waiver from HHS.

- Two or more members of a family whose combined cost of employer-sponsored coverage is considered unaffordable—to obtain this hardship exemption the taxpayer must meet the following three requirements:
  - The individual's required contribution for self-only coverage does not exceed the required contribution percentage of household income in § 5000A(e)(1)(A)

- The combined required contribution for self-only coverage for two or more employed members of the individual's family exceeds the required contribution percentage of household income, and
- The required contribution for family coverage that the employed members of the individual's tax household could enroll in through an employer exceeds the required contribution percentage of household income.

- Gross income below the applicable return filing threshold – the notice has the following clarification regarding this hardship:

> HHS intends to release additional guidance clarifying that this hardship exemption applies only to an individual who may not be claimed as a dependent by another individual. An individual eligible for this hardship exemption who files a Federal income tax return may claim a hardship exemption on the return for the taxable year without obtaining a hardship exemption certification.

- Individuals who obtained minimum essential coverage during the 2014 open enrollment period – This option provides some specific exemptions to deal with individuals who were unable to obtain coverage in a timely fashion from the exchanges, but who meet certain criteria. The provision clearly is meant to deal with the fact that the exchanges had significant issues during the original sign up phase.
- Certain individuals who applied for CHIP coverage during the open enrollment period for 2014 – As the notice provides:

> In guidance released on March 31, 2014, HHS provides that an individual is eligible for a hardship exemption if the individual applied for coverage under the Children's Health Insurance Program (CHIP) during the open enrollment period for 2014 and was found eligible for CHIP but had a gap in coverage prior to the effective date of the CHIP coverage.

- Individuals eligible for services through an Indian Health Care Provider
- Certain individuals residing in a state that did not expand Medicaid eligibility under section 2001(a) of the Affordable Care Act—this covers and individual who "resided in a state that did not expand Medicaid coverage and the individual's household income, within the meaning of § 36B, is below 138 percent of the applicable federal poverty level for the individual's family size."

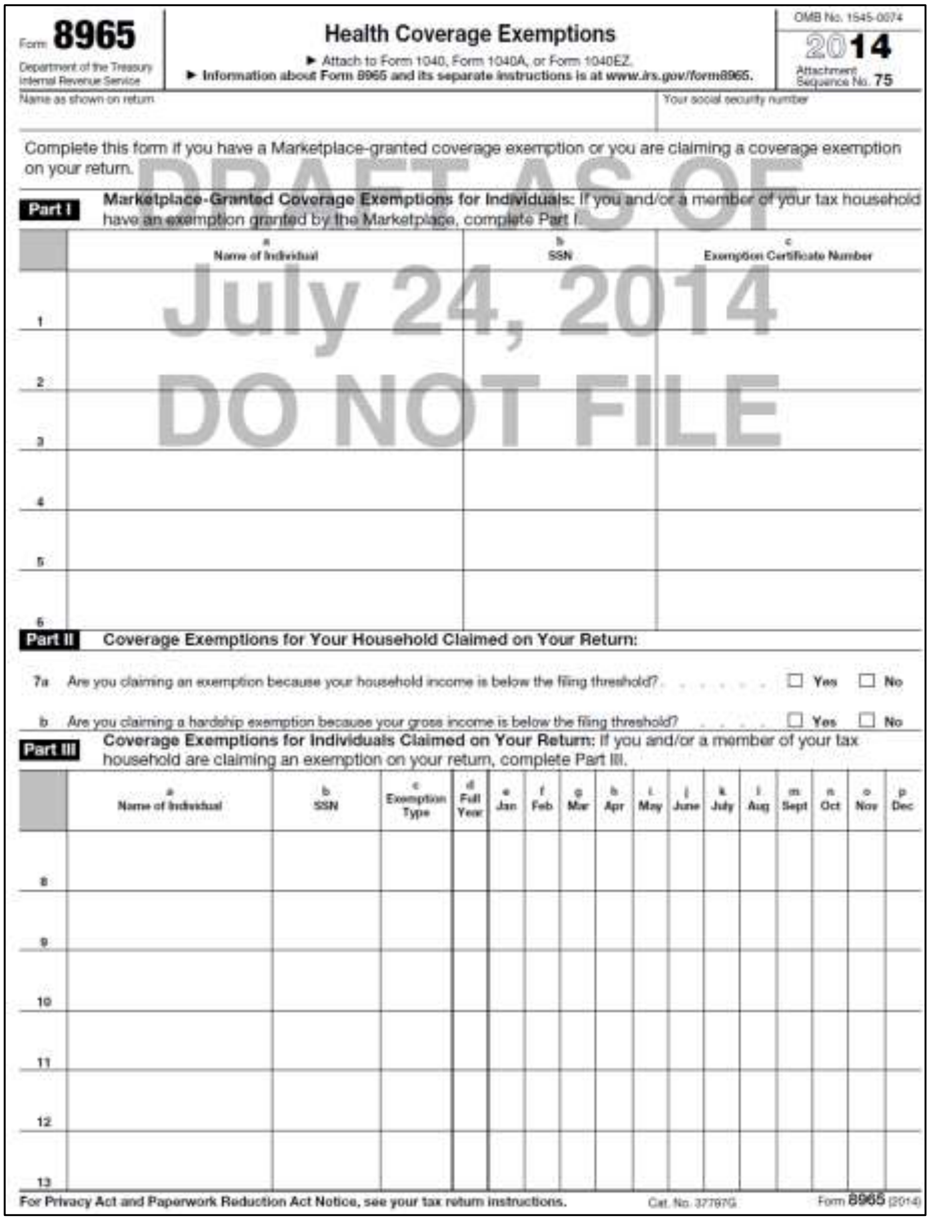
This notice was issued as a companion to the regulations under §5000A issued on the same day to provide the list of hardship exemptions for which a specific application to the exchange for a waiver will not be required.

Section: 5000A
Draft Form to Report Individual Shared Responsibility Payment Exemption Released by IRS

Citation: Draft Form 8965, 7/24/14

The IRS has issued a draft version of the form to be used to claim an exemption from the individual shared responsibility payment for health care coverage imposed by IRC §5000A.

The nature of any exemption will be disclosed on Form 8965 the draft of which may be downloaded from http://www.irs.gov/pub/irs-dft/f8965--dft.pdf.



Form **8965** Department of the Treasury Internal Revenue Service

Health Coverage Exemptions

► Attach to Form 1040, Form 1040A, or Form 1040EZ.
► Information about Form 8965 and its separate instructions is at www.irs.gov/form8965.

OMB No. 1545-0074 2014 Attachment Sequence No. 75

Name as shown on return | Your social security number

Complete this form if you have a Marketplace-granted coverage exemption or you are claiming a coverage exemption on your return.

DRAFT AS OF July 24, 2014 DO NOT FILE

Part I **Marketplace-Granted Coverage Exemptions for Individuals:** If you and/or a member of your tax household have an exemption granted by the Marketplace, complete Part I.

	a Name of Individual	b SSN	c Exemption Certificate Number
1			
2			
3			
4			
5			
6			

Part II **Coverage Exemptions for Your Household Claimed on Your Return:**

7a Are you claiming an exemption because your household income is below the filing threshold? . . . . . . ☐ Yes ☐ No

b Are you claiming a hardship exemption because your gross income is below the filing threshold? . . . . ☐ Yes ☐ No

Part III **Coverage Exemptions for Individuals Claimed on Your Return:** If you and/or a member of your tax household are claiming an exemption on your return, complete Part III.

	a Name of Individual	b SSN	c Exemption Type	d Full Year	e Jan	f Feb	g Mar	h Apr	i May	j June	k July	l Aug	m Sept	n Oct	o Nov	p Dec
8																
9																
10																
11																
12																
13																

For Privacy Act and Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37787G Form 8965 (2014)

Section: 5000A
IRS Discusses Individual Play or Pay Penalty When Parent Not Claiming Exemption Fails to Pay For Medical Insurance Under Court Order

Citation: IRS Information Letter 2013-0025, 10/18/13

In Information Letter 2013-0025 (http://www.irs.gov/pub/irs-wd/13-0025.pdf) the IRS points out that the taxpayer who claims the dependency exemption for a child will be "stuck" with the penalty under IRC §5000A if minimum essential coverage is not maintained on the child under proposed regulations.

The letter, issued in response to a request from a Congressman on behalf of his constituent, noted that the constituent had provided both a written comment and provided testimony on the matter, and that the IRS would "carefully consider her comments as we consider all comments received on these proposed regulations."

The letter goes on to describe that the law does offer a hardship option under the authority of the Department of Health and Human Services, and that HHS has provided that in certain cases a failure by the parent charged with providing the insurance under court order would be deemed a hardship. Reading between the lines, it appears likely that the IRS is going to "suggest" that such individuals will be required to seek hardship relief.

Section: 5000A
Individual Shared Responsibility Payment Regulations Finalized

Citation: TD 9632, 8/26/13

Final regulations (TD 9632, http://www.ofr.gov/OFRUpload/OFRData/2013-21157_PI.pdf) have been issued by the IRS for the individual "shared responsibility" payment under IRC §5000A, first applicable for 2014, that applies when a individual does not maintain minimum essential coverage for any month during the year. Unlike the large employer shared responsibility payment, this payment has not been pushed back to 2015.

The regulations, numbered Reg. §1.5000A-0 through 5, outline the various rules. Reg. §1.5000A-0 gives the table of contents guide to the other regulations. Reg. §1.5000A-1 governs the maintenance of minimum essential coverage and liability for the payment. Reg. §1.5000A-2 explains what is minimum essential coverage, listing types of coverage that will qualify. Reg. §1.5000A-3 outlines the individuals who are exempted from the payments. Reg. §1.5000A-4 outlines the computation of the payment, while Reg. §1.5000A-5 has general rules of administration and procedure.

The regulations begin at Reg. §1.5000A-1(a) by noting that the penalty applies for each month during a year that a non-exempt individual must maintain minimum essential coverage or pay the shared responsibility payment

A taxpayer will be treated as having minimum essential coverage for each month in which the individual is enrolled in and entitled to receive benefits in a program described in Reg. §1.5000A-2. [Reg. §1.5000A-1(b)]

An individual who resides outside the United States in a period that would meet either the bona fide residence test or the physical presence test for the foreign earned income exclusion is treated as having minimum essential coverage for each month of such period. Similarly, if the individual is a bona fide resident of a possession of a possession of the United States, he/she is treated as having qualifying coverage for the periods involved. [Reg. §1.5000A-1(c)]

An individual is liable for shared responsibility payments not only for him/herself, but also for any individual whom that person is eligible to claim as a dependent even if the taxpayer does not actually claim the individual as a dependent. [Reg. §1.5000A-1(c)(2)(i)]

Minimum essential coverage includes any of the following coverages [Reg. §1.5000A-2]:

- Government sponsored coverage
    - Medicare
    - Medicaid other than
        - Optional coverage of family planning services
        - Optional coverage of tuberculosis related services
        - Coverage of pregnancy related services (however the regulations indicate that guidance will be issued to hold that women covered by this program for a month will not be liable for a shared responsibility payment)
        - Coverage of emergency medical services
    - Children's Health Insurance Program (CHIP)

    - TRICARE and other programs under chapter 55 of US Code Title 10
    - Specific programs under Chapter 17 or 18 of U.S. Code Title 38
        - Medical benefits package for eligible veterans
        - Civilian Health and Medical Program of the Department of Veterans Affairs (CHAMPVA)
        - Comprehensive coverage for certain children of Vietnam Veterans and veterans of service in Korea who are suffering from spina bifida
    - Peace Corps plans
    - Nonappropriate Fund Health Benefit Program of the Department of Defense
- Employer Sponsored Plans
    - Governmental plans
    - Any plan or coverage offered in the small or large group market within a State
    - A self-insured group health plan offered by the employer to the employee
- Plan in Individual Market (Qualified Health Plans of a State Exchange)

Certain individuals are exempted from the shared responsibility payments. [Reg. §1.5000A-3] Those individuals include:

- Members of recognized religious sects or divisions that have a religious conscious exemption certification
- Individuals who are members of a §501(c)(3) health care sharing ministry (note that it must have been in existence at all times since December 31, 1999)
- Certain noncitizens
    - Individuals in the country illegally
    - Nonresident aliens
- Incarcerated individuals
- Other Special Exemptions
    - Taxpayers who cannot afford coverage (required annualized contribution is in excess of 8% of household income, with increases following 2014 to the extent premium growth outstrips income growth)
    - Taxpayers with income below the filing threshold (dependents are not tested here—rather the party that could claim them as a dependent must have income below the filing threshold)
    - Members of Indian tribes
    - Taxpayers with short term coverage gaps – an individual not covered for a single continuous period of less than 3 months during the year
    - Taxpayers that have suffered hardships

The shared responsibility payment for a month is 1/12 of the greater of [Reg. §1.5000A-4]

- The flat dollar amount which is the lesser of
    - The applicable dollar amount for each member of the family ($94 for 2014, $325 for 2015, $695 for 2016, indexed for inflation after that). For individuals under 18, the applicable dollar amount is ½ of these amounts
    - 300% of the applicable dollar amount for the year
- A percentage of the taxpayer's household income, set at 1.0% for 2014, 2.0% for 2015 and 2.5% after that

The payment is treated as an excise tax [Reg. §1.5000A-5], not subject to the deficiency procedures. The IRS is not allowed to use certain collection methods to collect this payment, specifically the filing of liens and levies are off limits to the IRS. As well, criminal penalties are waived for failure to comply with the requirement to maintain coverage.

Note that although the IRS is limited in its collection actions, it still has the full right to offset any refund otherwise due the taxpayer against any unpaid portion of the fee. [Reg. §1.5000A-5(b)(3)]

Section: 6013
Taxpayer Not Entitled to Joint Filing Status When Wife Refuses to Sign Any Document for the Federal Government

Citation: Salzer v. Commissioner, TC Summary Opinion 2014-59, 6/24/14

The fact that a taxpayer's spouse got upset with "activity that happened in the summer of 2008 with President Bush" and refused to sign a tax return with her husband for 2008 and 2009 with her husband because "not sign any forms from the federal government starting in that year…[because]…she has had issues with the federal government" did not excuse him from failing to file a return, or allow him to claim joint return filing status.

The case in question is that of Salzer v. Commissioner, TC Summary Opinion 2014-59, http://www.ustaxcourt.gov/InOpHistoric/SalzerSummaryArmen.SUM.WPD.pdf.

One issue was that Mr. Salzer's spouse had no income, so her refusal to sign a tax form wasn't an issue for her—she had no tax filing responsibility. But without her signature Mr. Salzer could not file a joint return.

Apparently he decided that this meant he either couldn't file a return or, given that the tax due with a married filing separately status would be much higher, simply decided not to do so.

When the IRS prepared a substitute for return (SFR) for him with married filing separate status, he protested that a) he should be able to file joint since he and his wife had done so for years before she decided to stop signing federal forms and b) if the IRS did that, he would actually be overpaid.

The Court pointed out that the signature (and therefore consent of) his spouse was required to file a joint return and without that he had to file married filing separately. While the court sympathized with his plight, it noted that the law provided no relief.

It turns out that Mr. Selzer may just need to hope that in 2016 someone wins the race for the White House that his wife likes better than she apparently does either the current or immediately past occupant of that position. Until then, he appears stuck with filing separate and paying higher taxes as "collateral damage" from his wife's feelings towards the federal government.

Section: 6013
Taxpayer Could Not Change from Married Filing Joint to Head of Household Filing Status on Amended Return Filed After the Original Due Date

Citation: CCA 201411017, 3/14/14

In CCA 201411017 (http://www.irs.gov/pub/irs-wd/11017.pdf) the Chief Counsel's office arrived at "win-win" ruling for the IRS—and "lose, lose" for the taxpayer. The issue in this case was an individual's attempt to both revise a previously filed tax return and change his filing status from married filing joint to head of household.

The individual had filed a joint return with his wife for the year in question. Sometime after the due date of the return but before the expiration of the statute of limitations the individual filed an amended return where he both claimed head of household status and reported adjustments to his return.

Presumably the husband could have qualified for head of household or joint filing status on the original return. For instance, under IRC §7703(b) a taxpayer whose spouse is not part of his household for the last six months of the year and furnishes over ½ of the cost of maintaining a household which is the principal place of abode for a child who would qualify as a dependent can file as head of household even though the individual is still legally married at year end.

However this gentleman did not utilize that option on the original return, rather making the joint return election under IRC §6013. However, that election cannot be revoked after the due date for the original return has expired (though taxpayers can make the election at a later date). [Reg. §1.6013-1(a)(1)]

So the ruling makes clear that the rule is not merely that you cannot file married filing separate after filing a joint return once the due date passes—rather, that you cannot change from married filing joint to any other status (assuming the married filing joint election is valid) after the due date for the return.

So is the amendment a non-entity? Not quite—the ruling goes on to note that since the husband had filed the amended return and the IRS had assessed tax based on that, the statute remained open to "correct" the original joint return, at least with regard to the husband (who was the only person to sign the return).

While the ruling starts with the question of whether it is valid against either husband or wife, the unredacted part of the ruling does not contain the answer. Presumably the redacted sections may have that answer (or at least a clue on the issue), but for now all we know is that the husband is potentially on the hook.

Section: 6038D
IRS Issues Final Regulations for Reporting Foreign Financial Assets Under FACTA

Citation: TD 9706, 12/12/14

The IRS has issued the final regulations on FACTA reporting obligations for individuals under IRC §6038D in TD 9706. These regulations implement, in final form, requirements imposed by the Hiring Incentives to Restore Employment Act for tax years beginning after March 18, 2010.

§6038D(a) requires individuals who hold interests in "specified foreign assets" statements to his/her individual income tax return if the aggregate value of such accounts exceeds $50,000. The information to be provided includes:

- In the case of an account, the name and address of any financial institution in which an account that is maintained;
- In the case of a stock or security, the name and address of the issuer and information to identify the class of stock or issue of security;
- For any other instrument
  - Information necessary to identify the item
  - Names and addresses of all issuers and counterparties to such instrument, contract or interest

- The maximum value of such asset during the year [§6038D(c)]

Specified foreign assets are:

- Financial accounts maintained by a foreign financial institutions;
- Any of the following not held in an account maintained by a financial institution:
    - Stock or security issued by other than a United States person;
    - Financial instrument or contract held for investment that has as a counterparty or issuer which is other than a United States person;
    - Any interest in a foreign entity

A taxpayer who fails to provide the information when required is hit initially with a $10,000 penalty for each year the taxpayer fails to report. If the taxpayer fails to provide the information within 90 days after the IRS notifies the taxpayer of his/her failure to file, the penalty jumps by $10,000 for each 30 day period or fraction of such period of such failure after the end of the 90 day period. [§6038D(d)]

The penalty may be waived for reasonable cause, though the fact that a foreign entity would impose a civil or criminal penalty on the taxpayer for such disclosure will not treated as reasonable cause. [§6038D(e)]

The taxpayer provides this information on Form 8938, "Statement of Specified Foreign Financial Assets" which the taxpayer files with his/her tax return for the year in question. The reporting is in addition to the FBAR reporting of often similar (or even identical) information made electronically on Form 114 to the U.S. Treasury by June 30 each year.

In December of 2011 the IRS issued temporary regulations for §6038D (TD 9567) and identical proposed regulations. These regulations replace the temporary regulations with final regulations, generally adopting the items in the temporary regulations with modifications discussed below.

However, the IRS did not release a final version of Reg. §1.6038D-6 that relates to "Specified Domestic Entities" which would detail the reporting obligations of taxpayers other than individuals.

The regulations issued in final form are:

- §1.6038D-1 Reporting with respect to specified foreign financial assets, definition of terms
- §1.6038D-2 Requirement to report specified foreign financial assets
- §1.6038D-3 Specified foreign financial assets
- §1.6038D-4 Information required to be reported
- §1.6038D-5 Valuation guidelines
- §1.6038D-7 Exceptions from the reporting of certain assets under section 6038D
- §1.6038D-8 Penalties for failure to disclose.

The IRS discussed various comments they received and either explained how they modified the regulation or, more often, justified why the IRS decided no change was needed from the final regulations. A summary of what the IRS changed and what they decided did not need to be changed is provided below.

§1.6038D-2 Requirement to report specified foreign financial assets

The IRS noted that the agency received a number of comments asking for relief by exempting various categories of taxpayers from the reporting requirements. The requested types, and the IRS responses, are noted below:

- Dual resident taxpayers – Dual resident taxpayers who may claim a treaty benefit as resident of a treaty partner. In such a case the taxpayer is treated as a nonresident. The final regulations were modified to exempt this taxpayer from having to file the reporting form so long as the taxpayer determines their tax liability to the U.S. as if they were a nonresident alien and claims a treaty benefit "as a nonresident of the United States as provided in §301.7701(b)-7 by timely filing a Form 1040NR, 'Nonresident Alien Income Tax Return,' (or such other appropriate form under that section) and attaching a Form 8833, 'Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).'" The IRS granted this relief because the IRS believes the Form 1040NR and Form 8833 will provide the IRS with the ability to identify individuals in this class and, if necessary, take enforcement action. [Reg. §1.6038D-2(e)]

- Individuals resident in the United States under non-immigrant visas – The IRS declined to waive the filing requirements for individual in the United on non-immigrant visas. The IRS stated "[b]ecause all U.S. residents are taxable on worldwide income, excluding categories of residents from the scope of section 6038D reporting is not consistent with the purposes for which the provision was enacted. Individuals in the United States under non-immigrant visas often stay in the United States for years, making it difficult to justify treating them more favorably than other U.S. residents."

- Persons that do not owe U.S. tax for the taxable year – The IRS also declined to exempt individuals who are required to file a U.S. return, but whose return shows no tax liability, from filing the disclosure forms with the return. The IRS states that the rules already exempt those that are not required to file a U.S. return, but "[I]f the law requires the filing of a tax return, however, information reported on a Form 8938 concerning the taxpayer's specified foreign financial assets is an important component of that return, even if no tax liability is shown. Requiring this filing will aid the IRS in devising effective enforcement programs with respect to such returns."

The IRS also received requests to raise filing thresholds in various situations or for various categories of assets.

- Assets received in connection with the performance of personal services – The IRS declined to adopt comments that requested either a higher threshold level or a total exemption from reporting for assets received in connection with the performance of services as an employee of a foreign employer. The IRS believes other provisions in the regulations address issues related to difficulties in valuing the asset, as well as providing that nonvested interests are generally not reported.

- Employees seconded to the United States – The IRS also declined to provide higher thresholds for employees seconded to the United States by foreign employers. The IRS believes the issues are addressed by the provisions dealing with individuals in the U.S. on nonresident visas and the provisions dealing with U.S. residents who do not qualify for the foreign earned income exclusion under IRC §911 (this group is discussed immediately below).

- Non-citizen U.S. residents who do not qualify for section 911 benefits – The IRS declined to extend higher reporting threshold to non-citizen U.S. residents who would have qualified for the provisions of §911(d)(1)(A) (the foreign earned income exclusion) if the individual had been a U.S. citizen. The IRS explains that the higher exemption was allowed for those filing Form 2555 because the filing of that form allows the IRS to identify these individuals and thus identify them for any possible enforcement issue. Since these non-U.S. citizens would not be filing the form, the IRS would not be to identify them, thus requiring (in the view of the IRS) the use of the lower thresholds.

The IRS received information requesting clarification of reporting requirements for certain types of assets.

- Nonvested property under section 83 – The final rule at Reg. §1.6038D-2(b)(2) provides that if a person receives what would be reportable property in connection with the performance of personal services, the item will first be reportable either on the first date the property is substantially vested or, if an election has been made under §83(b), the date of transfer of the property.

- Assets held by a disregarded entity – Assets held by a disregarded entity, whether foreign or domestic, are treated as held by the owner of the disregarded entity and must be reported by that individual. [Reg. §1.6038D-2(b)(4)(iii)]

- Jointly Owned Assets – Modifications were made to the reporting of jointly owned assets. Each of the joint owners of a specified asset must report the entire maximum value of the asset on his/her own return unless the owners are married to each other and file a joint return. [Reg. §1.6038D-2(c) and (d)]

§1.6038D-2 Requirement to report specified foreign financial assets

Various modifications were requested and discussed regarding the requirement to report various types of foreign assets.

- Retirement and pension accounts and certain non-retirement savings accounts – The IRS decided in the final regulations certain modifications were required in the area of such accounts. As the IRS describes it: “These final regulations modify the definition of a financial account for purposes of section 6038D in order to require consistent reporting under section 6038D with respect to retirement and pension accounts and certain non-retirement savings accounts regardless of whether the account is maintained in a jurisdiction treated as having in effect a Model 1 IGA or Model 2 IGA. For financial accounts that are maintained by a foreign financial institution that is not located in a jurisdiction treated as having in effect a Model 1 IGA or Model 2 IGA, the definition of a financial account in the final rule continues to include the retirement and pension accounts and non-retirement savings accounts described in §1.1471-5(b)(2)(i), consistent with the section 6038D coordination rule in that section. See §1.1471-5(b)(2)(i)(D). For taxable years beginning after December 12, 2014, these final regulations also provide that retirement and pension accounts, non-retirement savings accounts, and accounts satisfying conditions similar to those described in §1.1471-5(b)(2)(i) and that are excluded from the definition of a financial account under an applicable Model 1 IGA or Model 2 IGA (as provided in §1.1471-5(b)(2)(vi)) are included in the definition of a financial account for purposes of section 6038D. The Treasury Department and the IRS intend to amend the chapter 4 regulations to add a section 6038D coordination rule to

§1.1471-5(b)(2)(vi) providing that such accounts are included in the definition of a financial account for purposes of section 6038D."

- Short-term accounts – The IRS did not adopt a suggest that accounts held for a short period of time that generate a minimal amount of income not be reported. The IRS notes that rules in the proposed regulations already exempted many short term accounts (such as escrow accounts) because they are of a different nature. The IRS was not comfortable giving a blanket exemption.

- Request for examples of foreign financial assets not to be reported – The IRS declined the invitation to give additional examples of cases where foreign financial accounts will not need to reported.

Additional special case assets had commentators asking for changes to the proposed regulations.

- Assets held for investment and not used in, or held for use in, the conduct of the taxpayer's trade or business – The IRS declined to adopt a "bright line" test for assets that are deemed part of the taxpayer's trade or business and not held for investment, holding "[d]istinguishing assets held for investment from assets with a close nexus to the taxpayer's trade or business is an inherently factual determination that is not susceptible to a bright line test."

- Certain hedging transactions – The IRS also declined to adopt a blanket exemption from reporting of hedging transactions that meet the requirements of §1221(a)(7) (hedging transactions exempted from capital gain treatment).

- Employment contracts – The IRS also declined to give a blanket exemption to employment contracts due to the wide variety of property that might be covered by such a contract.

- Shares of foreign corporations traded on public stock exchange – The IRS also declined to exclude shares of stock that are traded on a public stock exchange, noting that if the stock was held in a foreign account it would be subject to reporting as a foreign account under §6038D and it didn't seem to make sense to have a different result if the security was taken out of the account.

- Financial assets issued by a person organized under the laws of a U.S. possession – Assets issued by person organized under the laws of a U.S. possession that otherwise meet the definition of a reportable asset are reportable assets per the final regulations. [Reg. §1.6038D-3(b)(1)]

- Request for Comments on the Treatment of Virtual Currency The IRS is requesting comments on how virtual currencies (such as bitcoin) should be treated for these purposes.

§1.6038D-5 Valuation guidelines

The IRS addressed two modifications to the proposed regulation on valuation.

- Asset With No Positive Value During the Year – If an asset has no positive value during the year it still must be reported, but the final regulations clarify at Reg. §1.6038D-5(b)(3) that the asset's maximum value during the year will be zero (that is, it won't reduce the aggregate value of assets, potentially bringing the value below the reporting threshold).

- Foreign Currency – Two modifications were made to the provisions regarding translating foreign currency into the equivalent amount of U.S. currency in determining if a taxpayer must report and then the amounts that should be reported. First, a taxpayer may rely upon foreign currency conversion shown on a periodic financial account statement. [Reg. §1.6038D-5(d)] Second, the IRS changed the name of the agency within the Treasury Department that issues the currency exchange rate to be issued. That rate is now issued by the Treasury Department's Bureau of the Fiscal Service.

Exceptions to the Reporting of Certain Assets

The IRS took notice of the fact that Form 8891, "U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans" will no longer be filed with tax returns beginning in 2015. Thus the regulations provide that reporting the asset on Form 8891 will relieve the taxpayer from having to report the account on Form 8938 only for years ending on or before December 31, 2013.

The IRS also added a rule that provides that a joint filer of Form 5471 will be considered to have the filed that form (and thus be relieved of detailed reporting of that information on Form 8938) so long as the taxpayer complied the requirements for a joint filer to provide the notice to the IRS under Reg. §1.6038-2(i) and §1.6038-3(c).

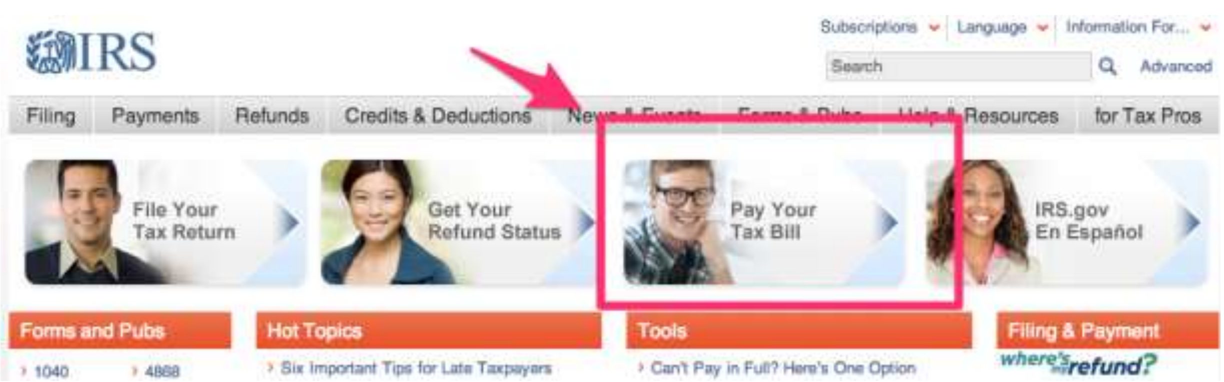
These regulations are generally applicable to taxable years ending after December 19, 2011. The taxpayer may elect to apply the regulations to earlier years.

Section: 6311
IRS Touts Initial Success of DirectPay Option for One Time Payments of Federal Taxes

Citation: IR-2014-67, 5/22/14

The IRS has announced that, as of late May 2014, 150,000 taxpayers had paid over $340 million via the IRS Direct Pay option found on the IRS homepage.

The link currently resides at the top of the IRS homepage as shown below:



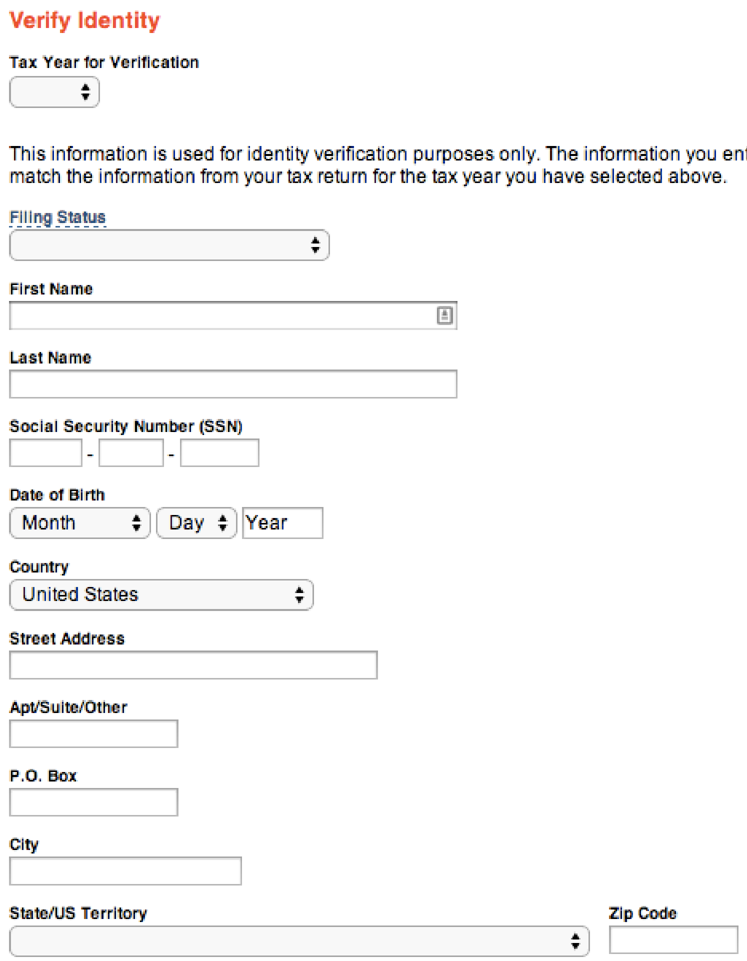
In News Release IR-2014-67 (http://bit.ly/IRSPay) the IRS noted that the Direct Pay service is a recently rolled out service of the IRS. Unlike EFTPS (which can also be used to pay these taxes) the Direct Pay system does not store the taxpayer's bank account information and has a much shorter process to verify the taxpayer's identity.

Clicking the main page link takes the taxpayer to the following list of options for payment of taxes:

The news release identifies the Direct Pay steps as:

- Providing your tax information
- Verifying your identity
- Entering your payment information
- Reviewing and electronically signing and
- Recording your online confirmation.

The identity verification page will ask the taxpayer for the following information:



Verify Identity

Tax Year for Verification

This information is used for identity verification purposes only. The information you enter should match the information from your tax return for the tax year you have selected above.

Filing Status

First Name

Last Name

Social Security Number (SSN)

Date of Birth

Month Day Year

Country

United States

Street Address

Apt/Suite/Other

P.O. Box

City

State/US Territory

Zip Code

Unlike the debit and credit card based options, there is no fee charged for using the Direct Pay service.

The use of the Direct Pay service is limited to individuals.

Section: 6707A
Tax Shown on Original Return, Not Amount Computed on Amended Return, Used to Compute Limitation on §6707A Disclosure Penalty

Citation: Yari v. Commissioner, 143 TC No. 7, 9/15/14

How to calculate the penalty for failing to disclose a listed transaction under IRC §6707A when the taxpayer erroneously overreported other income on the return is the issue the Tax Court was asked to decide in the case of *Yari v. Commissioner*, 143 TC No. 7.

The case in question involved a Roth IRA "stuffing" transaction where the taxpayer had a Roth IRA acquire 100% of the interest in a management S corporation. That corporation then charged management fees to the taxpayer's controlled business (a disregarded entity LLC), receiving $1,221,778 in such fees over the years from 2002 to 2007.

In Notice 2004-8 the IRS identified this sort of transaction as an abusive Roth IRA transaction. The IRS went to identify the transaction described in this notice as a listed transaction.

On October 17, 2005 the taxpayers signed their 2004 return and did not enclose a disclosure form related to this transaction as required under IRC §6707A.

The IRS examined the return and determined that $482,912 should have been included in the taxpayer's income due to the management fee transaction, increasing the taxpayer's liability by $135,215.

Originally IRC§ 6707A imposed a mandatory $100,000 penalty for the failure to attach a disclosure of a listed transaction to the tax return and the IRS initially assessed such a penalty on the return. While the taxpayer had a request for a collection due process hearing pending Congress retroactively modified the law to reduce the penalty to the greater of $5,000 or 75% of the decrease in tax shown on the return due to participation in that activity, with the penalty still capped at no more than $100,000.

The taxpayers had, in the interim, discovered errors on their returns as filed and prepared amended tax returns which served, even with the additional $482,912 in income from the management fee transaction reflected on the return, to reduce their tax to zero for the year in question. The taxpayers therefore asked the IRS to recalculate the penalty.

The IRS took this into consideration, but decided that the $100,000 amount was the correct penalty under the revised law. The IRS position was that the penalty was calculated based on the reduction in tax claimed on the return the taxpayer actually filed at the time, and not based on a recalculated tax based on other adjustments. Since 75% of $482,912 being more than $100,000, the IRS concluded that the penalty remained unchanged.

The taxpayers argued that the penalty should be computed based on the tax that would have been shown on the return after these adjustments. In that case the tax actually would not have changed, so the penalty would have been capped at $5,000.

The Tax Court agreed with the IRS. The court pointed out that §6707A refers to the reduction in tax claimed on the return where the failure to disclose took place. In the Court's view was that, under the plain language of the statute, this meant that the key issue was the claimed benefit at the point when the disclosure should have taken place (the original return).

The opinion contrasted the language in §6707A with a provision found in §6651(a)(2) which also imposes a penalty on the tax shown on the return, which would lead to the same result. There, the Court noted, Congress added IRC §6651(c)(2) which grants explicit relief if the actual required to be shown on the return was less than that reported on the return. The lack of any similar relief provision in §6707A indicates that Congress did wish the claimed benefits to be the basis for the penalty since, as the Court noted, Congress knows how to write a provision to base a calculation on the tax actually due.

Section: 7701
Letter on Treatment of Green Card Holders Published by IRS

Citation: Information Letter 2014-0033, 9/26/14

In Information Letter 2014-0033 the IRS gives a four page summary of the rules applicable to lawful permanent residents ("green card holders") related to U.S. income taxes.

The letter starts out with a general description of the taxation of an alien individual who is a lawful permanent residents of the United States under §7701(b)(6). Generally such an individual is one who has been lawfully granted the privilege of residing permanently in the United States as an immigrant and such status has not been revoked (including administratively or judicially determined to have been abandoned).

The letter notes that many green card holders are also treated as residents of a foreign country (referred to as a "dual resident taxpayer") and, assuming the United States has a tax treaty with that country that contains provisions found in the United States Model Income Tax Convention, will typically face "tiebreaker" rules that will apply to determine the residence.

The letter also discusses:

- United States residency starting date
- Special no-lapse rules that may apply to determine if a person is a resident for the current year
- Termination of lawful permanent resident status

The letter also discusses the application of IRC §§877 and 877A (which deal with reporting of unrealized gain upon expatriation from the United States) for lawful permanent residents who terminate their green card status.

The letter serves as a useful "quick reference" to provisions applicable to serving alien individuals who are looking to obtain, currently have or are thinking of termination lawful permanent resident status.

Section: 7701
Failure to Formally Abandon Lawful Permanent Resident Status Causes Individual to Be Subject to Tax on Worldwide Income

Citation: Topsnik v. Commissioner, 143 TC No. 12, 9/23/14

A German citizen failing to formally abandon his status as a lawful permanent resident of the United States proved costly to the taxpayer in the case of *Topsnik v. Commissioner*, 143 TC No. 12.

In 2004 Mr. Topsnik, a German citizen, entered into an installment sale of stock in a United States corporation. Payments were made on the notes from 2004-2009. Mr. Topsnik reported installment sale income on United States income tax returns for 2004 and 2005, though erroneously reporting the same amount on both returns. He filed no United States returns for the period from 2006 to 2009, the remaining term of the notes.

Mr. Topsnik had applied for and received a Form I-551 "Resident Alien" card (green card) in 1977. This made Mr. Topsnik a lawful permanent resident (LPR) of the United States and, under U.S. law, taxable on his worldwide income. In that same year he moved from Canada to Honolulu, Hawaii.

In 2002 Mr. Topsnik, when flying from Frankfurt, Germany to San Francisco, presenting himself as a returning LPR, signing an affidavit that he was returning home to Honolulu, that he was an owner of a U.S. company and that he traveled internationally on business. He also listed U.S.A. as the country of residence on his customs declaration.

He applied for and received renewal of his LPR status in March 2003 and given that status through March 2014. In November 2010 he formally abandoned the status by filing Form I-407, "Abandonment of Lawful Permanent Resident Status" where he stated his new residence would be in the Philippines and surrendered his green card.

Although he sold his Hawaii home in 2003, the new owner let him list it as his home address when traveling abroad and he received mail there which the new owner forwarded to him.

During the period in question the taxpayer had property in Germany and he was present in Germany, per his records, for various periods of time during the years in question, ranging from 14 to 98 days.

The IRS, noticing Mr. Topsnik had not filed returns, decided to look into his situation. The IRS discovered the issues with the duplicated data on the 2004 and 2005 returns, resulting in an assessment for additional tax on 2004. Similarly the IRS determined he had income in 2006-2009 due to his failure to report the installment sale income. The tax arose almost exclusively from income from the installment sale.

Mr. Topsnik claimed that he had informally surrendered his U.S. LPR status back in 2002, reverting back to a German citizen who was not subject to tax on the installment sale pursuant to the treaty between Germany and the United States on tax matters.

The IRS countered that, as an LPR, Mr. Topsnik was both not a resident of Germany and was subject to United States on his worldwide income. That situation continued until Mr. Topsnik formally abandoned his status in 2010.

The Tax Court began by looking at the definition, for tax purposes, of a lawful permanent resident. The Court cited Reg. §301.7701(b)-1(b)(1) that provides:

> Lawful permanent resident. -- (1) Green card test. -- An alien is a resident alien with respect to a calendar year if the individual is a lawful permanent resident at any time during the calendar year. A lawful permanent resident is an individual who has been lawfully granted the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws. Resident status is deemed to continue unless it is rescinded or administratively or judicially determined to have been abandoned.

Reg. §301.7701(b)-1(b)(6) provides information on how long status remains in place, providing:

> (6) Lawful permanent resident. -- For purposes of this subsection, an individual is a lawful permanent resident of the United States at any time if --
>
>> (A) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and
>>
>> (B) such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).
>
> An individual shall cease to be treated as a lawful permanent resident of the United States if such individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the Secretary of the commencement of such treatment.

The Court also looked at the relevant parts of the U.S.-Germany Treaty which generally provides a person is a resident of a country if the person is subject to tax by reason of his domicile, residence, place of management, place of incorporation or any other similar criteria.

In this case the taxpayer was arguing that his sale of his Hawaii residence amounted to the informal abandonment of his LPR status. He argued his residence moved to Germany at that time and, under the U.S.-Germany Treaty, as a resident of Germany he was not subject to the U.S. tax.

Mr. Topsnik cited a case involving a non-tax area of law (*United States v. Yakou*, 428 F.3d 241 (D.C. Cir. 2005) for the position that LPR status can be informally abandoned. The Tax Court countered that, unlike the issue in *Yakou*, this case involved the Internal Revenue Code which had specific provisions that had to be satisfied to abandon LPR status and have it recognized for income tax purposes. The Court, relying on the House Committee Report that accompanied adoption of the relevant tax provisions, notes that even if the taxpayer's visits to the United States become infrequent, he is still subject to tax until the formal abandonment of status takes place.

But under the treaty Mr. Topsnik had one other way to salvage his position that no tax was due—if he was a German resident, the Treaty provided that he would not be subject to tax. The problem was that Mr. Topsnik had not filed nor paid German tax for the years in question. While he presented evidence of how often he was in Germany, he never argued that he was subject to German tax for those years (presumably the German taxing authorities would have been interested in that concession). Since he did not argue he was subject to German tax, under the definition in the Treaty he had not established he was a German resident.

Section: 7701
State of Celebration Used to Determine Validity of Same Sex Marriage, However Registered Domestic Partnerships and Civil Unions Not Treated as Married if State Does Not Define Status as Married

Citation: Revenue Ruling 2013-17, 8/30/13

The IRS issued its eagerly awaited guidance of how the Supreme Court's Windsor decision would be applied overall in federal taxes in Revenue Ruling 2013-17 (http://www.irs.gov/pub/irs-drop/rr-13-17.pdf).

The ruling specifically looked to answer three questions that were not necessarily clear under the IRC following the Windsor decision:

- Would the IRS use, to borrow Justice Scalia's terms from his dissent, the state of current domicile, state of celebration or state of domicile at the time the marriage is entered into to determine marital status for federal tax purposes?
- Would there be a difference in dealing with IRC provisions that refer specifically to "husband," "wife," or "husband and wife" as opposed to those that refer only to "spouse" or similar gender-neutral terms?
- Does the treatment as married extend to couples in relationships defined by state law that are not denominated as marriage (such as registered domestic partners or civil unions) but may grant rights "as if" the couple were married?

To answer the first question (which state's laws control) the IRS turned initially to its analysis of common-law marriage issues found in Revenue Ruling 58-66. Under that ruling if a couple established a common-law marriage in a jurisdiction that recognizes the same, a later relocation to a state that refuses to recognize a marriage unless the couple has a formal marriage ceremony does not change their status as married for federal tax purposes.

The IRS notes, first, that this "once married, always married even if the couple relocates" has been used successfully for common-law marriages for over 50 years. The IRS also finds that a uniform rule gives a simpler tax administration than would be true under alternative treatments, including changes in "related party" status under various IRC provisions (for instance, IRC §318) for a couple merely by relocating to a state that did not recognize the marriage and complications for employers that operate in more than one state, greatly complicating administration of employee benefit plans.

Thus, the IRS has amplified Revenue Ruling 58-66 (the common-law marriage ruling) to cover same-sex marriages as well. So long as the marriage is valid in the state in which it is entered into, it will be recognized for federal tax purposes. A footnote to the ruling clarifies that the same rule would apply if the marriage were celebrated in a foreign jurisdiction that recognized the marriage.

The IRS also decided that it would not attempt to differentiate those provisions that contain a gender specific reference to parties in a marriage (that is "husband" and/or "wife") and rather treat all such references in a gender neutral form. Effectively this means that where such words are found, the adviser should simply read "spouse" or "spouses" instead of the gender specific wording.

Finally, the IRS also ruled that if a state establishes a status that is not deemed married under state law (such as a registered domestic partnership or a civil union) the parties will not be treated as married for federal tax purposes. This holding is contrary to an information letter issued back in 2011 by the IRS regarding Illinois civil unions involving opposite sex couples issued to a national tax preparation firm.

Finally there arises the question about what do about returns already filed or 2012 returns on extension and either not yet filed, or filed after the issuance of the Windsor decision. And, unfortunately, the ruling leaves some of these questions open.

The ruling clearly allows a taxpayer to rely on this ruling to file original returns, amended returns or claims for refund for any return for which the statute of limitations remains open. The ruling notes that if a taxpayer does file such a claim for refund, the return must consistently treat the couple as married for all purposes—so the taxpayer cannot "cherry pick" to exclude the value of medical insurance paid for a same-sex spouse from income but ignore dealing with negative consequences that arise due to being required to use a rate schedule of either married filing joint or married filing separately.

The ruling does note that the ruling will be applied prospectively as of September 16, 2013. The IRS in its FAQ released along with the ruling holds that if a 2012 return is not actually filed by September 16, 2013, the taxpayer must file using either married filing jointly or married filing separately. However, a taxpayer who files before that date has the option of filing using either the married status or filling as if DOMA had not been overturned (that is, as not married).

Since a "marriage penalty" occurs in most (but not all) cases for income tax purposes, some taxpayers may now be facing a filing deadline one month earlier than they believed would apply.

The IRS indicated that we should expect additional guidance with regard to refunds of payroll taxes for benefits paid in prior periods that are not taxable when provided to a spouse and how to deal with employee benefit plan issues for periods before the effective date of the ruling (September 16, 2013). After that date, such individuals are to be treated as married for benefits and withholding purposes.

Similarly, we are warned that other agencies (the Department of Labor with the shared jurisdiction for ERISA plans is an obvious such agency) will also be issuing guidance on programs that are affected by the IRC.

BUSINESS DEVELOPMENTS

Section: 36B
Plans that Fail to Offer Significant In-Patient Hospitalization and/or Physician Coverage Will Not Offer Minimum Value

Citation: Notice 2014-69, 11/4/14

In Notice 2014-69 the IRS has issued a warning regarding certain employer health plans it has learned about that have been designed to provide no, or extremely limited, in-patient hospitalization and/or physician coverage but still, due to quirks in the online minimum value calculator, be found to provide "minimum value" for health insurance.

The notice provides that plans that fail to provide significant in-patient hospitalization and/or physician coverage do provide minimum value and that regulations will shortly be issued to that effect.

Under the Affordable Care Act, a "large" employer may owe penalties it fails to provide affordable coverage that provides minimum value to its employees. Thus, the plans described above would not qualify as coverage that would allow an employer to escape the "pay or play" penalty if an employee were to qualify for assistance for a health care program purchased from the state exchange.

However, recognizing that the current regulations allow for such a program, the IRS has announced that if an employer has a pre-November 4, 2014 binding commitment to participate in such a program, the plan will be allowed to use the mechanical minimum value test for 2015 so long as the plan's year begins no later than March 1, 2015.

Section: 41
Alternative Simplified Research Credit Election to Be Allowed on Certain Amended Returns

Citation: Temporary Reg. §1.41-9T, TD 9666, 6/2/14

The IRS has released Temporary Regulation §1.41-9T (TD 9666, https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-12757.pdf) to expand the options for making the election to use the alternative simplified research credit computation under IRC §41(c)(5). Specifically the regulations will now allow a taxpayer to make the election to use the alternative simplified credit (ASC) method on an amended income tax return.

The original 2011 regulations provided that this election could only be made on an original return and even went so far as to provide that the IRS would not grant late election relief under the procedures found at Reg. §301.9100-3 that normally are available to request the ability to make a regulatory election after the date specified in the regulations.

The relief is not complete. As the preamble to the regulations notes:

> However, permitting changes from the regular credit to the ASC on amended returns could result in more than one audit of a taxpayer's research credit for a tax year. Accordingly, the temporary regulations provide that a taxpayer that previously claimed, on an original or amended return, a section 41 credit for a tax year may not make an ASC election for that tax year on an amended return.

The regulation also provides that if the taxpayer is a member of a controlled group, it may not make the late election if any other member of the controlled group claimed a credit using a method other than ASC for that tax year on a previously filed original or amended return.

The regulations will apply to taxable years ending on or after June 3, 2014. Under Temp. Reg. §1.41-9T(b)(2) an election may also be made, if otherwise eligible, for any prior year for which the statute has not yet expired.

Section: 42
Impact of Failure to Maintain Nonprofit Organization Involvement for Period of Time For Housing Credit Partnership Required to Meet §42(h)(5)(B) Rules Explained

Citation: CCA 201352009, 12/27/13

In CCA 201352009 (http://www.irs.gov/pub/irs-wd/1352009.pdf) the Chief Counsel's office was asked to address the consequences of failing to meet the requirements under IRC §42(h)(5)(B) on the involvement of a qualified nonprofit in housing credit projects that enable a state to meet the requirements of IRC §42(h)(5) to set aside 10% of its annual state housing credit allocation to projects involving nonprofit organizations.

In the case that gave rise to the memo, the partnership had sought to remove its nonprofit general partner for cause. The partnership had notified the state of this removal and was given a period of time by the state to find a replacement nonprofit general partner. The partnership was unable to do so during the time period granted by the state, at which point the state notified the IRS of noncompliance. The partnership after that date was able to find a new nonprofit organization to assume general partner status and the state notified the IRS of the fact the organization was back in compliance.

The memo concludes that the proper consequence of a period of noncompliance is the loss of credit for any tax year where the noncompliance is not corrected as of the end of the tax year. The memo reasons that the IRC implies there would be some sort of negative consequence of the failure to maintain compliance with the IRC §42(h)(5)(B) requirement during the compliance period, but concluded that Congress did not intend for such a failure to be treated as the equivalent of a disposition of the building or ownership interest, triggering recapture of the credit.

Section: 45R
IRS Issues Proposed Final Regulations on Post-2013 Small Employer Health Care Credit

Citation: TD 9672, 6/30/14

The IRS has issued final regulations (TD 9672, https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-15262.pdf) for the small business health care credit under §45R which reflect the revisions that take place beginning in 2014.

The regulations generally incorporate the guidance previously given in Notice 2010-44 and 2010-82. One change required by the law is that for tax years beginning during or after 2014, the small employer's coverage must be offered to employees through a small business health options program (SHOP) exchange.

Special rules are provided to deal with the potential problems that may exist for an employer with a health plan year that does not begin on January 1, and therefore may not be able to offer employees a SHOP based plan as of the first day of the year. If, as of August 26, 2013 the employer offers coverage under a plan with a plan year that begins on a date other than the first date of the plan year, and that coverage qualifies under the 2013 rules for the credit, the employer will be treated as offering coverage under a SHOP plan for the entire year so long as it offers coverage via a SHOP program on the first day of the plan year beginning during the taxable year.

It is important to remember that, beginning in 2014, the credit will be limited to a maximum of two consecutive years beginning with the year in which the employer first offers one or more qualified plans to its employees via a SHOP exchange. The proposed regulations outline the application of this provision, something that was not an issue in the earlier guidance.

The regulations also outline how an employer can meet the uniform percentage contribution requirement to be eligible for the credit. An employer must make pay a uniform percentage, not lower than 50 percent, of the premium for each employee. The regulations provide rules to meet this test for various scenarios. The rules vary depending on whether the premium for the qualifying plan charges a "composite billing" (a uniform premium for each employee or a single aggregate premium for a group of employees) or a "list billing" (where the insurer charges a separate premium for each employee based on factors such as age). As well, the rules consider cases where the plan offers only self-only coverage or includes family coverage with a higher premium. Finally, the rules deal with a case where the employer offers either a single qualifying health plan (QHP) or multiple QHPs.

The simplest case is for an employer with composite billing and only self-only coverage. In that case, the employer simply must pay the same amount toward the premium of each employee and that amount must be at least 50% of such premium.

An employer that also offers coverage under the QHP beyond self-only coverage (such as family coverage), an employer can meet the requirements by paying a uniform amount for the higher cost tier of coverage that is the same for each employee in that tier and is no less than is paid for the self-only coverage. Effectively, this allows the employer, if it wishes, to require employees to pay the full cost of such additional coverage or subsidize it entirely.

Alternatively, the employers may separately test each tier of coverage using the basic "self-only" test described earlier. Thus, the employer would need to pay more than 50% of the cost of the allocable premium for each employee, and the same amount for each employee in that particular tier. However a different amount and percentage (so long as it's at least 50%) could be used for each particular tier class.

If a employer is faced with "list" billing the employer can meet the test either by paying a uniform percentage of not less than 50% for each employee or can, effectively, covert the list billings into an employer-computed composite premium for self-only coverage and each employee with coverage pays the same amount towards self-only coverage that is no more than 50% of the employer-computed composite premium.

If an employer offers more than one SHOP plan it has two options. First, it can separately test each QHP under the above tests. Alternatively, the employer can use a "reference plan" method to meet the tests. The employer designates one of the QHPs as the reference plan and computes an employer contribution that would, if all employees enrolled in the reference plan, satisfy the uniform percentage rules for that plan. The employee can then apply that employer contribution either to the reference plan or to one of the other plans.

The final regulations mention one change made to get around a State rule that could have caused issues for the "uniform percentage" requirements for employer contributions:

> The Treasury Department and the IRS understand that at least one State requires employers to contribute a certain percentage (for example, 50 percent) to an employee's premium cost, but also requires that the employee's contribution not exceed a certain percentage of monthly gross earnings; as a result, in some instances, the employer's required contribution for a particular employee might exceed 50 percent of the premium. To satisfy the uniform percentage requirement under section

45R, the employer generally would be required to increase the employer contribution to all of its employees' premiums to match the increase for that one employee, which may be difficult, especially if the percentage increase is substantial. An employer will be treated as meeting the uniform percentage requirement if the failure to satisfy the uniform percentage requirement is attributable to additional employer contributions made to certain employees solely to comply with an applicable State or local law.

The final regulations apply to taxable years beginning after December 31, 2013, however employers will be allowed to rely on provisions in the prior proposed regulations for tax years beginning after 2013 and before 2015.

Section: 61
Auto Dealer Facility Upgrade Payments Must Be Recognized In Income Upon Receipt, Do Not Reduce Basis of Constructed Improvements

Citation: AM2014-004, 5/9/14

The IRS National Office in Memorandum AM2014-004 (http://bit.ly/AM2014-004) takes the position that payments made to auto dealer under certain auto dealer facility upgrade programs from manufacturers must be included currently in income and do not serve to reduce the basis of either assets constructed to meet the requirements of the manufacturers to receive payments in the facilities upgrade program or the basis of vehicles purchased and included in inventory.

The memorandum was written in response to an inquiry regarding inconsistent treatment of such programs by auto dealers. Some dealers were asserting the payments were contributions to capital excludable under IRC §118 and served only to reduce the basis of the constructed property under IRC §362(c)(2).

Other dealers and a trade association did not argue that §118 applied, but rather that the payments were simply a reduction in the basis of the assets constructions, arriving at the same result but without the detour through IRC §118.

Finally some manufacturers had devised the program so that if a dealer met the requirements the adjustment would be made to the amounts charged to the dealer for inventory and so took the position that the credits were inventory price adjustments.

In all cases the net income would eventually "wash out" though if the item reduced the basis of the asset it would only come into income over the depreciable life of the asset while in the inventory case some of the amount would be tied up in the year end inventory.

The IRS National Office rejected all three positions. The IRS eliminated the §118 argument, which seems to attract a lot of taxpayers for various circumstances, though it rarely actually applies. A key problem is that the payment from the payor has to be motivated by a concern for something like the general welfare of the community and the payor receives no benefit. That is not the case here, thus the §108/§362 argument would not apply.

The National Office took the position that the dealers were responsible for contracting with the appropriate parties and therefore had full ownership of the properties. The IRS did not see this as "similar" to a purchase price rebate. While the memo is not totally clear on the point, it seems likely a major IRS objection is that the manufacturer had no care whatsoever over what contractor was used and/or the source of materials. Rather they just generally wanted an "improved" site. This makes the case different than one where a rebate is paid by the manufacturer to the eventual retail buyer of a vehicle, which would be a purchase price adjustment.

Finally, the IRS did not find that “wrapping” this around an inventory price adjustment changed the result. The point of this program was not, at least directly, to encourage the dealer to sell more cars. Rather, it was to get the dealer to improve its facilities.

Section: 61
IRS Addresses Tax Treatment of Bitcoin (or Other Virtual Currencies That May Develop)

Citation: Notice 2014-21, 3/25/14

In recent years there has been the development of a significant “virtual currency” (Bitcoin). The payment system (which is effectively what Bitcoin is) offers anonymity to users, and can be used to purchase various items. While gathering attention for use as payments for illegal activities (clearly it offers significant benefits there), the system is also used by some legitimate businesses since it nicely sidesteps the transaction costs imposed by more traditional payment systems (like credit cards).

The unit of currency (a Bitcoin) fluctuates in price vs. more traditional currencies—in fact, the price has risen and fallen dramatically at times. In fact, after rising above $1,000 per Bitcoin in late 2013, the price fell to below $500 the week of the IRS announcement (though the vast majority of the decline had taken place earlier). But the price is still more than double where it was a year before the IRS announcement.

And we should note the “price” noted above isn’t quite that precise—the numbers above are based on Coindesk’s Bitcoin Price index, which uses an average of two Bitcoin exchanges. So suffice it to say this is extremely volatile and not necessarily easy to tie down a value.

As well, the currency is created by a process known as “mining” which involves solving math problems that are used to provide the security for the system. So while one can buy Bitcoin on various exchanges by giving traditional currency, it’s also possible to create your own Bitcoin (although the processing power needed has grown dramatically, meaning it may cost more in terms of simple electric power than a miner can receive in currency).

However the taxation of Bitcoin and similar virtual currencies was not necessarily clear. The IRS has moved to resolve some of these issues in Notice 2014-21 (http://www.irs.gov/pub/irs-drop/n-14-21.pdf). The notice was issued in the form of a series of frequently asked questions and answers.

Generally the ruling provides that Bitcoin and similar virtual currencies are property and not currency for federal tax purposes. This has the practical result, given the varying value on a daily basis of Bitcoin, that a user will compute a gain or loss when exchanging Bitcoin for a product, service or traditional currency. How that gain or loss is taxed is determined by the same rules that affect dispositions of property generally—which means determining if the Bitcoin property is investment property, inventory, personal property, etc.

Some of the key rulings include:

- A person who receives Bitcoin (or any other virtual currency—we’ll use Bitcoin here for simplicity) for goods or services must include the value of the Bitcoin in the computation of gross income. The value would be the value of the Bitcoin in U.S. currency at the time it is received (with the practical valuation problem noted above). The IRS does provide, at Q&A5 of the FAQ, that if a currency is listed on an exchange that is established by market supply and demand, that exchange value would be used to determine the fair value in U.S. currency.

- Q&A 6 specifically holds that the holder of Bitcoin who then uses that to acquire a product or service will have a gain or loss on the conversion, again measured by the fair value at the time the Bitcoins are used to acquire the good or service. The gain or loss is measured by comparing that value to the taxpayer's basis in the Bitcoins surrendered, which would generally be what the taxpayer had paid for the Bitcoin or the value recognized when the Bitcoins were received by the taxpayer in an initial exchange or at the time of mining.
- The gain or loss recognized is determined by the nature of the Bitcoin property in the hands of the taxpayer prior to the exchange.
  - If the Bitcoin is investment property (the taxpayer was speculating in Bitcoin, for instance), then there would be a capital gain or loss
  - If the Bitcoin is inventory to the taxpayer (as it would be for a Bitcoin exchange), then the gain or loss would be ordinary
  - If the Bitcoin is personal property, any gain would be capital in nature (and taxable) but losses would not be deductible. Interestingly enough, the IRS does not mention this type of property in the FAQ
- The taxation of "miners" is outlined in Q&As 8 and 9. A miner recognizes income equal to the fair value of the Bitcoin at the time it is mined and such income would, at least in the view of the IRS, be self-employment income if earned by an individual.
- Employees and independent contractors paid in Bitcoin have income at the time of receipt of the Bitcoin equal to the fair value of the Bitcoin at the time of receipt. The payments are subject to all of the withholding and reporting rules that generally apply to any such payments. Thus, a business paying its employees in Bitcoin would issue W-2s to those emloyees. Similarly, a business paying more than $600 for services to an unincorporated independent contractor during the year would issue a Form 1099MISC to that contractor. As well, the business would need to obtain a Form W-9 from the contractor and a contractor that refused to provide the required information would be subject to backup withholding.
- The IRS also ruled that entities that contract as an intermediary to settle payments between merchants and their customers in virtual currency would be considered a third party settlement organization and required to issue Forms 1099-K if the requirements are met, in the same way as is done for credit cards and organizations like Paypal.

The IRS also provided that there will not be a blanket waiver of penalties for not having treated a transaction under these rules prior to March 25, 2014 (when the ruling was issued). However the IRS does indicate that the general reasonable cause relief may apply.

Most likely those who reasonably and innocently run afoul of these provisions will be granted relief. But an individual who was using Bitcoin transactions to "stay off the radar" and escape notice will not likely find any relief will be given if their transgressions come to light.

As a practical matter, this ruling is going to make things a bit more difficult for businesses that accept Bitcoins in payment since a gain or loss has to be computed each time the virtual currency is converted to cash or used for paying expenses. And it's important to note that the ruling provides no "safe harbor" time period where a vendor would be allowed to use the redemption price as the value of the Bitcoin. So prudence suggests that a vendor would probably want to have the Bitcoin converted to cash immediately upon receipt.

Section: 61
IRS Sets Annual Limits On Value of Vehicles for Cents Per Mile and Fleet-Average Valuation Rule

Citation: Notice 2014-11, 3/20/14

In Notice 2014-11 (http://www.irs.gov/pub/irs-drop/n-14-11.pdf) the IRS has set the maximum values for 2014 for employer provided vehicles under which the cents per mile method (Reg. §1.61-21(e)) or fleet-average valuation rule (Reg. §1.61-21(d)) may apply.

The maximum value of vehicles for which the cents per mile method may be used for 2014 is:

- $16,000 for a passenger automobile
- $17,000 for a truck or van

The maximum value of vehicles for the fleet valuation rule for 2014 is:

- $21,300 for a passenger vehicle
- $22,600 for a truck or van

Section: 61
IRS Publishes Updated SIFL Rates

Citation: Revenue Rulings 2013-20 and 2013-8, 9/26/13

For employers using the noncommercial flight valuation rule, the IRS publishes updated terminal charges and mileage rates every six months.

If an employer elects to apply the noncommercial flight valuation rule to a flight that is not provided to the general public on a per-seat basis, the employer must use this method for all eligible flights for all employees during the calendar year [Reg. §1.61-21(g)(14)].

To calculate the noncommercial flight valuation rule, the employer starts with the appropriate SIFL base charge. The rate is adjusted twice annually, normally announced sometime in the first two months of the period to which the revised rate will apply.

For the second half of 2013 the rates are as follows:

[Revenue Ruling 2013-20 and Department of Transportation Web Site http://ostpxweb.dot.gov/aviation/domfares/siflb.pdf]

Period during which flight is taken	Terminal Charge	SIFL Mileage Rates
7/1/13 – 12/31/13	$48.53	Up to 500 miles = $0.2654 per mile 501-1500 miles = $0.2024 per mile Over 1500 miles = $0.1946 per mile

For the first half of 2013 the rates are as follows:

[Revenue Ruling 2013-8 and Department of Transportation Web Site http://ostpxweb.dot.gov/aviation/domfares/siflb.pdf]

Period during which flight is taken	Terminal Charge	SIFL Mileage Rates
1/1/13 – 6/30/13	$48.54	Up to 500 miles = $0.2655 per mile 501-1500 miles = $0.2024 per mile Over 1500 miles = $0.1946 per mile

The amount computed using the SIFL mileage rate (but not the terminal charge) is then multiplied by a factor from the table found at Reg. §1.61-21(g)(7):

Maximum certified takeoff weight of aircraft	Aircraft multiple for a control employee	Aircraft multiple for a non-control employee
6,000 lbs or less	62.5 percent	15.6 percent
6,001 – 10,000 lbs	125 percent	23.4 percent
10,001 – 25,000 lbs	300 percent	31.3 percent
25,000 lbs or more	400 percent	31.3 percent

Section: 66
Tax Owed on Community Share of Income from Partnership in 2003 Based on Final Settlement Agreement Signed in 2006

Citation: Carrino v. Commissioner, TC Memo 2014-34, 2/26/14

A taxpayer who did not know she had an interest in a partnership in the year in question was nevertheless found to be taxable on its income in the case of *Carrino v. Commissioner*, TC Memo 2014-34, http://www.ustaxcourt.gov/InOpHistoric/CarrinoMemo.Holmes.TCM.WPD.pdf.

Ann Carrino, a resident of California, had legally separated from her husband in June of 2002. Shortly after the separation her husband (Vince) used community funds to start up what became a very successful hedge fund—but apparently did so without Ann's knowledge or consent.

Ann did eventually become aware of this use of funds and, in November 2006, a state court approved the couple's settlement where 72.5% of the then current value of Vince's investment was community property. Vince then had the partnership file an amended return for 2003 and Ann was listed as a partner, with a K-1 showing the income allocable to ½ of that portion of Vince's interest.

An interesting aside noted in a footnote to the case is that Vince's refund claim was actually disallowed by the IRS (see footnote 8) and Vince's attempt to protest the IRS disallowance of his refund claim was dismissed by the Tax Court (due to lack of jurisdiction).

Ann attempted to argue some very detailed provisions of California community property law and as well tried to prove that she wasn't a partner under the IRC—but the Tax Court found neither point relevant. What the Court did find relevant was that the agreement simply recognized the fact that Ann had a community property interest in the partnership income from the very beginning. The fact that she may not have been aware of that fact and the partnership itself had filed an original return not indicating her as a partner was not relevant.

While Ann argued that she had no real interest until November of 2006 when the agreement was approved, the Court noted that the agreement called the property community and, in fact, Ann had argued from the start that the interest was community property.

The Court found it wasn't necessary to decide if Ann was a partner—rather, under California law, Ann possessed a present interest in the partnership's income from its inception. That made her taxable on that interest without having to worry about whether she was an actual partner. Although the IRS had not raised the issue, the Tax Court noted that under Reg. §1.702-1(d) if a partnership interest represents community property, the income must be reported by the spouses in equal proportions if they file separate returns.

Thus, even though the IRS's denied Vince's refund claim, it was still allowed to collect tax on ½ of the community partnership income from Ann.

The case is one of those that indicates the unique issues faced when community property rules are involved. Advisers should note that state law, and not federal law, generally determines the ownership of income and while community property rules are similar in the community property jurisdictions, each state has its own unique quirks. Thus, advice may need to be sought from legal counsel skilled in the application of the provisions for the state in question when handling such matters.

Section: 83
Employee Granted Revocation of §83(b) Election When Letter Ruling Request Filed Before Expiration of Original Period to Elect Treatment

Citation: PLR 201441006, 10/10/14

Once a taxpayer makes an election under IRC §83(b) the taxpayer is generally "stuck" with the consequences unless the taxpayer can convince the IRS to allow the taxpayer to revoke the election. In PLR 201441006 a taxpayer was able to convince the IRS to allow a "do over" on an election the taxpayer apparently quickly came to regret making.

In this case the taxpayer made the election shortly after receiving an award of restricted common stock from his employer. Very shortly thereafter the taxpayer decided this was a mistake and the taxpayer filed a request with the IRS to revoke the election. The election was filed prior to the expiration of the original 30 day period to make the original election.

The IRS noted that, generally, under Reg. §1.83-2(f) a request to revoke an election under §83(b) will be granted only if the request is made due to a mistake of fact as to the underlying transaction and the request is made within 60 days of the date on which the mistake was first made known to the taxpayer.

However the ruling points out that in Revenue Procedure 2006-31 the IRS provided that it will also generally grant a request to revoke a §83(b) election if the request to revoke is made before the expiration of the period for making the original election—that is, 30 days after the restricted property is received by the service provider.

In this case the request was made within that time period and, therefore, the IRS granted the request to revoke the election.

The good news is that while undoing the election does require a private letter ruling (and the expenses related to the same), if the request is made within the period for making the original election relief is virtually automatic. However the problem is that an adviser who discovers a taxpayer made a potentially ill-advised election will have very little time to discuss the option with the client, have the client decide whether to proceed, and then finally prepare and submit such a ruling request.

This is not a situation an adviser is likely to run across more than once in his or her career—but being aware of the special rule and its short time frame for taking advantage of it will prove extremely valuable in that one case.

Section: 83
IRS Finalizes Clarifications to Substantial Risk of Forfeiture Under §83

Citation: TD 9659, 2/26/14

The IRS issued revisions to the regulations on restricted property (Reg. §1.83-3(c), TD 9659, https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-03988.pdf) that added language to, in the IRS's view, clarify the application of the law.

When the changes were issued in proposed form, some argued this would narrow the circumstances under which there would be a substantial risk of forfeiture. The IRS, responding in the preamble to the final regulations to a comment that indicated a belief that the regulations resulted in a change in circumstances that would qualify, specifically rejected that view.

As the IRS comments:

> These regulations are intended to clarify the definition of a substantial risk of forfeiture and are consistent with the interpretation that the IRS historically has applied, and therefore from the perspective of Treasury and the IRS they do not constitute a narrowing of the requirements to establish a substantial risk of forfeiture.

From a practical standpoint this means the IRS believes these regulations are effectively applicable to transactions that took place prior to their effective date, since they just explain the law as it already existed.

The regulations made additions to the text found in Reg. §1.83-3(c).

- The regulations explicitly provide that a "papered over" restriction that is put in a document but is not likely to be actually enforced will not constitute a substantial risk of forfeiture ("Property is not transferred subject to a substantial risk of forfeiture if at the time of transfer the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced.")
- Restrictions on the transfer of property, standing alone, will only be considered a substantial risk of forfeiture if they meet the requirements of Reg. §1.83-3(j) (related to sales that give rise to suit under Section 16(b) of the Securities Act of 1934) or Reg. §1.83-3(k) (restrictions imposed to comply with "Pooling-of-Interests Accounting" rules). The regulations also make clear the above two provisions are the only "non-service related" considerations generally.

The final regulations also contain new examples illustrating the application of the revisions (or, in the IRS's view, clarifications).

Section: 83
Failure to Attach Copy of §83(b) Election to Recipient's Tax Return Did Not Invalidate Election

Citation: PLR 201405008, 1/31/14

The regulations that deal with making an election under IRC §83(b) provide that a taxpayer must file a copy of the election with the IRS office where the taxpayer will file his/her return within 30 days after the transfer and the taxpayer *shall* file a copy with the taxpayer's return for that year. [Reg. §1.83-2(c)]

So an interesting question arises—what happens if a taxpayer files the statement within 30 days but fails to attach a copy of the election to his/her tax return? Is there still a valid election, or did the failure to attach a copy with the tax return render the election null and void?

A taxpayer whose preparer accidentally neglected to attach the statement to the tax return sought the IRS's counsel on fixing the situation in PLR 201405008 (http://www.irs.gov/pub/irs-wd/1405008.pdf). Technically the taxpayer was asking for an extension of time to file the copy of the election.

The IRS didn't directly grant the requested relief. Rather the IRS concluded that:

> Based on the representations made and after consideration of the provisions of sections 83(b) of the Code and 1.83-2 of the Regulations we have determined that you fulfilled the requirements for a valid election under section 83(b) when your statement was mailed to the Internal Revenue office on Date 2. *Failure to submit a copy of the statement with your Year 1 tax return did not affect the validity of the election.*

Thus, the IRS found a valid election already existed. The taxpayer is asked to forward a copy of the election to the Service Center to be associated with the taxpayer's return.

The ruling is of interest because, from time to time, taxpayers may end up with "elector's remorse" following a §83(b) election when the entity's fortunes turn sour after the election is made but before the return is due. Some may suggest simply "failing" the requirements by not attaching the election and then treating the election as having failed.

It is likely concern about that sort of planning led the IRS to decide, effectively, that relief was not necessary. The ruling indicates that failing to attach the copy of the election to the return would not allow a taxpayer to "undo" a §83(b) election where it becomes clear by the date the return is filed that the election has proven disadvantageous.

Section: 83
Clause in Employment Contract That Conditioned Loss of Stock on Discharge for Cause Was Still Found to Be Substantial Risk of Foreiture

Citation: Austin v. Commissioner, 141 TC No. 18, 12/16/13

If an employment agreement provides that an employee will only forfeit shares if the employee is discharged for cause, does that mean that they don't have a substantial risk of forfeiture under §83? The question arises because the regulations under IRC §83 provides that if an employee only forfeits if discharged for cause that is not not a substantial risk of forfeiture.

In the case of *Austin v. Commissioner*, 141 TC No. 18, http://www.ustaxcourt.gov/InOpHistoric/AustinDiv.Lauber.TC.WPD.pdf, the employee had such a clause in their contract with the employer. Nevertheless they argued that they had a substantial risk of forfeiture as the term was defined for §83—and the Tax Court agreed with that view.

In the agreement in question, the cause included if the taxpayer failed to "faithfully and diligently performing the usual and customary duties of his employment."

The Tax Court concluded that the "for cause" reference in the regulation did not mean the same thing as the general definition of "for cause" found in employment law—and certainly not as referenced in this agreement.

The Court found that:

> Rather, as used in the regulation, "discharged for cause" refers to termination for serious misconduct that is roughly comparable--in its severity and in the unlikelihood of its occurrence--to criminal misconduct.

The Court concluded this based on its review of the development of the regulation from its proposed to final status, and the Court noted that the "for cause" was inserted only in the final regulation, and that the IRS effectively deemed it a minor change in a clause the previously referred to criminal conduct and the like.

In this case, the Court found that the defined level of conduct that would give rise to discharge for cause would not nearly so serious as to rise to the level contemplated in the regulations.

Section: 106
Department of Labor Clarifies in FAQ Types of Employer Arrangements that Run Afoul of Notice 2013-54

Citation: Notice 2013-54, 9/13/13 andDepartment of Labor FAQ, 11/6/14

In Notice 2013-54 (http://www.irs.gov/pub/irs-drop/n-13-54.pdf) and Department of Labor Technical Release 2013-03 (http://www.dol.gov/ebsa/newsroom/tr13-03.html) the IRS and DOL described issues that arise regarding rules applicable under the Affordable Care Act. A further clarification of issues related to this notice was published in November of 2014 by the post of a set of frequently asked questions to the Department of Labor web site.

Two problem areas arise for self-insured HRAs under the "market reform" provisions of the ACA.

First, those provisions require non-grandfathered employer plans to remove lifetime and annual limits on benefits to employees. Second, the plans must provide, at no cost, certain preventative services. If an HRA is forced to meet these requirements the program would become prohibitively risky for most employers.

The Notice, adopting guidance previously provided in the form of FAQs issued by the IRS, HHS and DOL, provides the following HRAs are exempted from meeting these requirements:

- An HRA that covers fewer than two current employees (this is a statutory exemption)
- An HRA that offers only exempted benefits (that is, no coverage of essential medical benefits)
- An HRA that is integrated with employer offered group coverage that provides minimum value
    - Only employees who either participate in the group plan or have equivalent coverage (such as coverage under a spouse's employer plan) may participate in the HRA
    - The employee must have the right, at least annually, to permanently opt out of and waive future benefits under the program
    - The HRA may not be "integrated" with individual health plans (such as would be the case with a plan designed around Revenue Ruling 61-146)

The problems faced with employer reimbursement of employee's individuals premiums is outlined specifically in Question 1 of the Notice which reads as follows:

> ***Question 1*:** The HRA FAQs provide that an employer-sponsored HRA cannot be integrated with individual market coverage, and, therefore, an HRA used to purchase coverage on the individual market will fail to comply with the annual dollar limit prohibition. May other types of group health plans used to purchase coverage on the individual market be integrated with that individual market coverage for purposes of the annual dollar limit prohibition?
>
> ***Answer 1*:** No. A group health plan, including an HRA, used to purchase coverage on the individual market is not integrated with that individual market coverage for purposes of the annual dollar limit prohibition.
>
> For example, a group health plan, such as an employer payment plan, that reimburses employees for an employee's substantiated individual insurance policy premiums must satisfy the market reforms for group health plans. However the employer payment plan will fail to comply with the annual

> dollar limit prohibition because (1) an employer payment plan is considered to impose an annual limit up to the cost of the individual market coverage purchased through the arrangement, and (2) an employer payment plan cannot be integrated with any individual health insurance policy purchased under the arrangement.

The notice also discusses flexible spending arrangements (FSAs). While noting that the FAQs originally stated that FSAs would be exempted from the market reform rules (the limits on benefits and the preventive care mandate), the notice clarifies that this was intended solely for FSAs that are part of a §125 cafeteria plan.

Question 8 of the Notice states:

> **Question 8:** The interim final regulations regarding the annual dollar limit prohibition contain an exemption for health FSAs (as defined in Code § 106(c)(2)). See 26 C.F.R. §54.9815-2711T(a)(2)(ii), 29 C.F.R. §2590.715-2711(a)(2)(ii), and 45 C.F.R. §147.126(a)(2)(ii). Does this exemption apply to a health FSA that is not offered through a Code § 125 plan?
>
> Answer 8: No. The Departments intended for this exemption from the annual dollar limit prohibition to apply only to a health FSA that is offered through a Code § 125 plan and thus subject to a separate annual limitation under Code § 125(i). There is no similar limitation on a health FSA that is not part of a Code § 125 plan, and thus no basis to imply that it is not subject to the annual dollar limit prohibition.
>
> To clarify this issue, the Departments intend to amend the annual dollar limit prohibition regulations to conform to this Q&A 8 retroactively applicable as of September 13, 2013. As a result, a health FSA that is not offered through a Code § 125 plan is subject to the annual dollar limit prohibition and will fail to comply with the annual dollar limit prohibition.

Effectively, this ruling makes the use of Revenue Ruling 61-146 impractical (assuming an employer truly does not want to offer absolutely unlimited reimbursement of all medical costs for everyone) programs where the employer pays for employee's individual policies. Employers who have used such programs will either need to stop reimbursing such payments.

In November of 2014 the Department of Labor issued further clarification on this provision. The first question dealt with the Department's view regarding a method that had been used to attempt to continue to provide such coverage.

Some commentators had suggested that the issue could be solved by having an employer simply make a reimbursement payment and include the amount in the employee's W-2. The FAQ makes clear that merely labeling the payment "after tax" will not solve the issue.

The FAQ provides:

> **Q1: My employer offers employees cash to reimburse the purchase of an individual market policy. Does this arrangement comply with the market reforms?**
>
> No. If the employer uses an arrangement that provides cash reimbursement for the purchase of an individual market policy, the employer's payment arrangement is part of a plan, fund, or other arrangement established or maintained for the purpose of providing medical care to employees, <u>*without regard to whether the employer treats the money as pre-tax or post-tax to the employee*</u>. Therefore, the arrangement is group health plan coverage within the meaning of Code section 9832(a), Employee Retirement Income Security Act (ERISA) section 733(a) and PHS Act section 2791(a), and is subject to the market reform provisions of the Affordable Care Act applicable to group

> health plans. Such employer health care arrangements cannot be integrated with individual market policies to satisfy the market reforms and, therefore, will violate PHS Act sections 2711 and 2713, among other provisions, which can trigger penalties such as excise taxes under section 4980D of the Code. Under the Departments' prior published guidance, the cash arrangement fails to comply with the market reforms because the cash payment cannot be integrated with an individual market policy.

Thus, continuing to do the same reimbursement as before but simply including it in the employee's W-2 is not sufficient. As well, any linkage between the pay for employee and that employee obtaining medical insurance coverage is likely to be seen by the DOL as an impermissible health plan due to the inability to integrate the pay with a market policy.

The key item to note is that the penalty under §4980D is (and always has been) a penalty tax on an impermissible health plan of an employer, not a penalty tax only on pre-tax health plans.

The FAQ also goes on to note two other "impermissible" structures with regard to an employer health plan.

First, it finds that an employer who offers high risk employees a choice between enrollment in its standard plan or cash is also in violation of the rules governing health plans.

That FAQ provides:

> **Q2: My employer offers employees with high claims risk a choice between enrollment in its standard group health plan or cash. Does this comply with the market reforms?**
>
> No. PHS Act section 2705,(7) which was incorporated by reference into ERISA section 715 and Code section 9815, as well as the nondiscrimination provisions of ERISA section 702 and Code section 9802 originally added by the Health Insurance Portability and Accountability Act (HIPAA), prohibit discrimination based on one or more health factors. Offering, only to employees with a high claims risk, a choice between enrollment in the standard group health plan or cash, constitutes such discrimination. While the Departments' regulations implementing this provision(8) permit more favorable rules for eligibility or reduced premiums or contributions based on an adverse health factor (sometimes referred to as benign discrimination), in the Departments' view, cash-or-coverage arrangements offered only to employees with a high claims risk are not permissible benign discrimination. Accordingly, such arrangements will violate the nondiscrimination provisions, regardless of whether (1) the cash payment is treated by the employer as pre--tax or post--tax to the employee, (2) the employer is involved in the selection or purchase of any individual market product, or (3) the employee obtains any individual health insurance.
>
> Such offers fail to qualify as benign discrimination for two reasons. First, if an employer offers a choice of additional cash or enrollment in the employer's plan to a high- claims- risk employee, the opt- out offer does not reduce the amount charged to the employee with the adverse health factor. Rather, the employer's offer of cash to a high -claims- risk employee who opts out of the employer's plan effectively increases the premium or contribution the employer's plan requires the employee to pay for coverage under the plan because, unlike other similarly situated individuals, the high- claims-risk employee must accept the cost of forgoing the cash in order to elect plan coverage. For example, if the employer's group health plan requires all employees to pay $2,500 toward the cost of employee -only coverage under the plan, but the employer offers a high- claims- risk employee $10,000 in additional compensation if the employee declines the coverage, for purposes of discrimination analysis, the effective required contribution by that high- claims -risk employee for plan coverage is $12,500 – that is, the $2,500 required employee contribution for employee- only coverage under the

employer's plan plus the $10,000 of additional compensation that the employee would forgo by enrolling in the plan. Because a high- claims- risk employee must effectively contribute more to participate in the group health plan, the arrangement violates the rule that a group health plan may not on the basis of a health factor require any individual (as a condition of enrollment) to pay a premium or contribution which is greater than the premium or contribution for a similarly situated individual enrolled in the plan.

> Second, the Departments' regulations generally permit providing, based on an adverse health factor, enhancements to eligibility for coverage under the plan itself but not cash as an alternative to the plan. In particular, the regulations permit providing plan eligibility criteria that offer extended coverage within the plan and subsidization of the cost of coverage within the plan based on an adverse health factor.(9) An example in the Departments' regulations illustrates that a plan may have an eligibility provision that provides coverage to disabled dependent children beyond the age at which non-disabled dependent children become ineligible for coverage. Another example in the regulations illustrates that a plan may provide coverage free of charge to disabled employees, while other employees pay a participant contribution towards coverage.(11) However, in the Departments' view, providing cash as an alternative to health coverage for individuals with adverse health factors is an eligibility rule that discourages participation in the group health plan. This type of arrangement differentiates based on a health factor and is outside the scope of the Departments' regulations on benign discrimination, which permit only discrimination that helps individuals with adverse health factors to participate in the health coverage being offered to other plan participants. The Departments intend to initiate rule-making in the near future to clarify the scope of the benign discrimination provisions.

> Finally, because the choice between taxable cash and a tax--favored qualified benefit (the election of coverage under the group health plan) is required to be a Code section 125 cafeteria plan, imposing an effective additional cost to elect coverage under the group health plan could, depending on the facts and circumstances, also result in discrimination in favor of highly compensated individuals in violation of the Code section 125 cafeteria plan nondiscrimination rules.

Finally, the FAQ looks at a plan being marketed to set up a §105 medical reimbursement plan that claim to allow employees to qualify for assistance and/or tax credits while having an employer provide a reimbursement.

That FAQ notes:

> **Q3: A vendor markets a product to employers claiming that employers can cancel their group policies, set up a Code section 105 reimbursement plan that works with health insurance brokers or agents to help employees select individual insurance policies, and allow eligible employees to access the premium tax credits for Marketplace coverage. Is this permissible?**

> No. The Departments have been informed that some vendors are marketing such products. However, these arrangements are problematic for several reasons. First, the arrangements described in this Q3 are themselves group health plans and, therefore, employees participating in such arrangements are ineligible for premium tax credits (or cost--sharing reductions) for Marketplace coverage. The mere fact that the employer does not get involved with an employee's individual selection or purchase of an individual health insurance policy does not prevent the arrangement from being a group health plan. DOL guidance indicates that the existence of a group health plan is based on many facts and circumstances, including the employer's involvement in the

overall scheme and the absence of an unfettered right by the employee to receive the employer contributions in cash.

Second, as explained in DOL Technical Release 2013-03, IRS Notice 2013-54, and the two IRS FAQs addressing employer health care arrangements referenced earlier, such arrangements are subject to the market reform provisions of the Affordable Care Act, including the PHS Act section 2711 prohibition on annual limits and the PHS Act 2713 requirement to provide certain preventive services without cost sharing. Such employer health care arrangements cannot be integrated with individual market policies to satisfy the market reforms and, therefore, will violate PHS Act sections 2711 and 2713, among other provisions, which can trigger penalties such as excise taxes under section 4980D of the Code.

Clearly, the Department of Labor is on the lookout for "workarounds" that attempt to use the individual market to provide an employee benefit.

What probably does work is simply adjusting the pay upwards for those who are losing employer provided coverage and then letting them know that they are "on their own" for the purchase of health coverage. An employer must avoid the temptation to somehow "link" the acquisition of health care insurance with the amount of pay, as well as giving "bonuses" that appear to be tied to declining to take health insurance. Similarly, an employer almost certainly should not paying the premiums directly on an individual policy for an employee (aside from the "one employee" plans that aren't covered by the PHS Act.

Section: 108
C Corporation Treatment of §108(i) Acceleration Rule Addressed in Final Regulations

Citation: TD 9622, 7/3/13

The IRS issued final regulations that impact C corporations that have deferred recognition of cancellation of indebtedness income under §108(i). These regulations deal largely with the provisions of the acceleration of inclusion of the deferred gain under the provisions of §108(i)(5)(D). Generally that section provided that gain would be accelerated on certain events which include "the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances..." per the statute.

The IRS held that while technically appearing to be a triggering event, it would be contrary to the stated goal of §108(i) for the acceleration provisions to apply to transactions where §381(a) applies to allow the acquiring corporation to succeed to the tax attributes of the acquired corporation, specifically in the liquidation of a subsidiary under §332 or a transfer in an A, C, D, F or G reorganizations where §361 applies. Thus the regulations hold that such transactions will not be triggering events to accelerate the recognition of income.

Rather under the regulations a C corporation will trigger acceleration if certain events that threaten ultimate collection of the tax take place. Those events are 1) a change in the entity's tax status, 2) the cessation of existence of the corporation in a transaction to which §381(a) does not apply or 3) engages in a transaction that reduces the net value of the corporation to such an extent that the ultimate collection of the tax is threatened. The regulations provide a net value acceleration rule test that, if violated, will trigger the recognition in the third circumstance.

Generally the net value acceleration rule is triggered generally if a corporation enters into an "impairment transaction" and the corporation at that points fails a mechanical net value test. An impairment transaction is any transaction that impairs the corporation's ability to pay the amount of the Federal income tax liability on the deferred COD income. Specifically such transactions would include distributions (including §381(a) transactions), redemptions, below market sales, donations and incurrence of additional indebtedness without a corresponding increase in asset value. Excluded from the treatment are value for value exchanges, including ones to which §351 (tax free incorporation) or §721 (tax free contributions to partnerships) apply.

If an impairment transaction takes place, the net value acceleration rule is triggered if the gross value of the corporation's assets is less than 110% of the sum of the corporation's total liabilities and the tax on the net amount of the tax that would be due on the deferred items under §108(i). The tax due is computed by using the tax that would due at the highest applicable rate for the taxable year on the outstanding deferral, even if the corporation's actual tax rate is not that rate.

If the acceleration provision is triggered, then the entire remaining deferral is subject to tax at the time of the impairment transaction. However a corporation can escape this treatment if value is restored to the corporation by the due date of the corporate return, including extensions. The corporation must restore the lesser of the value of amounts that were removed in one or more impairment transactions (net of any amounts previously restored under this option) or the amount of the shortfall under 110% rule.

Special rules are provided that allow a member of a consolidated group to, at any time, trigger all of its remaining deferred COD income.

The regulations also provide that earnings and profits are not increased for the deferred amount of income until such time as the item is brought into income for the corporation.

Generally the rules apply to acceleration events occurring on or after August 11, 2010.

Section: 125
New Options Provided Where Cafeteria Plan May Allow Participants to Revoke Health Plan Participation Election During Plan Year

Citation: Notice 2014-55, 9/25/14

In Notice 2014-55 the IRS added new categories of permitted changes for a participant in a cafeteria plan to revoke the election for employer-provided health care coverage during the plan year. Generally an employee is "stuck" with the election initially made for the period of the plan year unless certain events occur. The events in question must be both ones that the IRS rules governing §125 allow as an event that can trigger an election change and the plan document governing the §125 plans provides that the event in question is an event allowing a change under that plan.

The Notice will allow plans to adopt amendments to allow participants to revoke their election for employer-provided health care coverage where their expected hours of work falls below 30 hours, but that hourly reduction does not, by itself, render the employee ineligible for coverage under the plan. As the notice indicates, some employers have changed their programs to remove such hour limitations to avoid any potential for penalties under the "pay or play" rules under §4980H.

Unfortunately, this means an employee who goes from full-time to part-time would be stuck with the premium they had agreed to fund at the beginning of the year when their income drops. That would be true even if the employee now qualified for other coverage and no longer needed the employer coverage. This change allows the plan to provide an option for the employee to "opt-out" of continuing coverage.

However, this option would only be open if the employee (and any other party covered by his/her election, such as dependents) enroll in another plan providing minimum essential coverage with coverage effective no later than the first day of the second month following the month when the employee revoked his/her coverage.

The other case where a plan could add the option for the employee to revoke his/her election is the case where the employee opts to obtain coverage from one of the health care Marketplaces, but the beginning date for such coverage doesn't coincide with the employer plan's start of a new plan year. Such an employee would be stuck with either paying for duplicative coverage for a period, or having a period during which the employee had no coverage.

In this case the employee may revoke if the employee is qualified for enrollment in a plan offered by a Marketplace and the employee indicates that he/she plans to enroll in such coverage no later the day immediately following the day on which the coverage terminates under the plan previously acquired via the cafeteria plan.

In both cases plans may begin operating as if their plans had amendments allowing for such an option immediately, but a plan amendment offering this option (and complying with the provisions the employer used in the interim) must be formally adopted by the plan prior to the plan's year end for the year in which the plan offers the option. As well, the plan must inform all employees of the amendment. However, an election to revoke coverage on a retroactive basis will not be allowed.

Section: 125
IRS Outlines Interaction of FSA Carryover Rules with HSA Eligibility

Citation: Chief Counsel Advice 201413005, 3/28/14

In Chief Counsel Advice 201413005, http://www.irs.gov/pub/irs-wd/1413005.pdf, the IRS outlined the impact of a health FSA carryover on an employee's eligibility for a health savings account in the carryover year.

In Notice 2013-71 (http://www.irs.gov/pub/irs-drop/n-13-71.pdf) the IRS granted a limited exception the well known "use it or lose it" provision that impacts health flexible spending accounts in cafeteria (§125) plans. If a plan chooses to adopt the provision, the plan may allow an employee to carry over up to $500 of unused health FSA funds into the following year.

However, the question arises about the impact on that employee's eligibility to fully fund a health savings account in the following year if the FSA is not a limited purpose one. Individuals may only contribute to an HSA during periods when they a) have a qualifying high deductible health insurance plan and b) have no other disqualifying coverage.

The memo poses seven questions in a form that outlines how the IRS views the interaction of the HSA rules and the new provisions for allowing FSA carryovers.

- An employee who is covered by a general purpose health FSA, even if only due to a carryover from the prior year, is not an eligible individual for HSA funding purposes.
- The disqualification does not end before the end of the plan in question even though the employee might exhaust the carryover in the first month of the year.
- If an employer offers both a general purpose FSA and an HSA compatible FSA and the plans allow, an employee who designates his/her carryover amount to be directed to the HSA-compatible FSA would not lose eligibility, even if the carryover arose from a general purpose FSA.
- An employer who offers both a general purpose and HSA-compatible FSA may automatically treat employees who elect HDHP coverage for the year as participating in the HSA compatible FSA and direct any carryovers there.
- A plan may also allow an employee who participates in a general purpose FSA that allows for a carryover to waive the carryover to the following year and, if the employee does so, the employee

will not lose eligibility. This provides a secondary option for an employer that does not offer (nor wish to offer) an HSA compatible FSA along with a general purpose one, but still wants to allow its employees to be able to get the full benefit for funding an HSA if they switch over to an HDHP.

- An employee who has the carryover from a general purpose FSA to an HSA-compatible one may, during the run-out period, still receive reimbursement under the general purpose FSA provisions for expenses incurred prior to the end of the general purpose FSA plan year.

To illustrate the last provision the IRS offers the following example:

> Example: Employer offers a calendar year general purpose health FSA and a calendar year HSA-compatible health FSA. Both FSAs provide for a carryover of up to $500 of unused amounts and do not have a grace period. Employee has an unused amount of $600 in the general purpose health FSA on December 31 of Year 1. Prior to December 31 of Year 1, Employee elects $2,500 in the HSA-compatible health FSA for Year 2 and elects to have any carryover go to the HSA-compatible health FSA. Employee also elects coverage by an HDHP for Year 2. Example: Employer offers a calendar year general purpose health FSA and a calendar year HSA-compatible health FSA. Both FSAs provide for a carryover of up to $500 of unused amounts and do not have a grace period. Employee has an unused amount of $600 in the general purpose health FSA on December 31 of Year 1. Prior to December 31 of Year 1, Employee elects $2,500 in the HSA-compatible health FSA for Year 2 and elects to have any carryover go to the HSA-compatible health FSA. Employee also elects coverage by an HDHP for Year 2.

Employers who offer a variety of health benefits will likely wish to study the analysis in this ruling to understand the design options available to maintain the ability for employees to transition to an HSA program.

Section: 125
Windsor Decision Implications for Cafeteria Plans Outlined by IRS

Citation: Notice 2014-1, 12/16/13

In Notice 2014-1, http://www.irs.gov/pub/irs-drop/n-14-01.pdf, the IRS ruled that cafeteria plans may allow same-sex married couples to make midyear election changes during plan years containing June 26, 2013 (the date of the *Windsor* decision) or December 16, 2013 (the date the notice was issued). The election will be allowed due to a change in legal marital status under the plan.

The change in status must be effective no later than the later of the "(a) the date that coverage under the cafeteria plan would be added under the cafeteria plan's usual procedures for change in status elections, or (b) a reasonable period of time after December 16, 2013."

If the employee was paying for coverage for the same-sex spouse with pre-tax dollars due to the employer's belief the spouse wasn't eligible to be covered by the plan, the employer is to treat the amounts as a pre-tax salary reduction so long as the employer receives notice of the employee's marital status by the end of the plan year that contains December 16, 2013. That includes giving notice by simply filing a revised Form W-4.

A plan may permit reimbursement of a same-sex spouse's medical expenses from an FSA no earlier than the beginning of the plan year that includes June 26, 2013 or the date of the employee's marriage, if later.

A same-sex married couple is subject to a married couple's limit on HSA contributions. Similarly, the same-sex married couple faces a single $5,000 limit on dependent care FSA contributions.

The notice indicates that generally a plan will need to be amended to allow compliance with this notice. However, if the plan choses to permit changes that weren't previously allowed under the plan document, then an amendment would be required.

Section: 125
Optional $500 Carryover for Health FSAs May Be Adopted by Employers in §125 Plans

Citation: Notice 2013-71, 10/31/13

The IRS announced that it was modifying the "use it or lose it" rule applicable to health flexible spending arrangements in Notice 2013-71 (http://www.irs.gov/pub/irs-drop/n-13-71.pdf). The IRS had previously indicated it was considering such an option in Notice 2012-40 when it announced guidance on implementing the $2,500 Health FSA contribution limitation first effective for 2013.

For plan years beginning on or after January 1, 2013, an employer may modify a health flexible spending arrangement in a cafeteria plan to allow for up to a $500 carryforward of unused amounts to future years. An employer, however, cannot provide for a grace period if it allows a carryover for the plan year.

This poses a quandary of sorts. The grace period amount is not limited (except to the extent of the overall $2,500 limit from the prior year), but it is only for the first two and a half months of the following year. The carryover runs for the entire year, but is limited to the smaller amount.

As well, the IRS cautions that if a plan already contains a grace period provision applicable for 2013, the employer likely is prevented from adding a $500 carryforward for 2013. The Treasury reasoned that employees may have planned on using the grace period to spend funds when originally deferring for 2013.

An employer does not need to offer either option. The employer may continue to retain the full use it or lose it rule and allow for no grace period following the end of the year.

Whatever option is chosen must be provided for in the §125 plan documents—that is, not all participants in all §125 plan will have access to either of these options.

The IRS will provide guidance on amendments, and such amendments must be adopted by December 15, 2014 to be effective for plan years beginning January 1,2014.

Section: 132
IRS Modifies and Provides Examples of Use of Electronic Media to Provide Excludable Employer Provided Transit Benefit

Citation: Revnue Ruling 2014-32, 11/21/14

In Revenue Ruling 2014-32, the IRS provides examples of employer provided transportation benefits via electronic media, indicating whether the program in question qualifies as an excludable transportation benefit under §§132(a)(5) and 132(f) of the Internal Revenue Code.

Under §132(a)(5), an employer may provide to an employee a qualified transportation benefit that is excluded from the employee's income, subject to certain limitations.

Such a fringe benefit can be transit pass, which includes any pass, token, farecard, voucher or similar item entitling the person to qualified transportation. A cash reimbursement may be used in lieu of such passes, etc., but only if such a voucher or similar item is not readily available to the employer to be distributed directly to the employee. Such reimbursement program must include reasonable procedures to insure that only transit is being reimbursed.

In the notice the IRS posed the following situations, in each case then describing it the arrangement was one where the value could be excluded from the employee's compensation and the reasons why or why not.

The first fact pattern was as follows:

> **Situation 1.** Employer A provides to its employees transportation benefits in an amount not exceeding the statutory monthly limit under § 132(f)(2) (the statutory monthly limit). Transit system X provides smartcards that may be used by employers in the metropolitan area served by X to provide fare media for transit system X to employees. Smartcards are cards that contain a memory chip storing certain information that uniquely identifies the card and value stored on the card, and that can be used either as fare media or to purchase fare media. The amount stored on the smartcard provided by transit system X is usable only as fare media; it cannot be used for any other purpose or to purchase anything else. A uses the smartcards to provide transportation benefits to its employees. A makes monthly payments to X on behalf of its employees who participate in the transportation benefit program, which X then electronically allocates to each employee's smartcard as instructed by A. A does not require its employees to substantiate their use of the smartcards.

The IRS holds that these reimbursements are excludable from the employee's income. The ruling provides:

> In Situation 1, the fare media value stored on the smartcards is usable only as fare media for transit system X. Thus, the smartcard qualifies as a transit pass under §§ 132(f)(5)(A) and § 1.1329(b) Q/A-3 distributed in-kind by A to its employees. In addition, the amount allocated to each employee's smartcard is within the amount specified by § 132(f)(2)(A). Accordingly, the value of the fare media provided by A to its employees through the smartcards is excluded from the employees' gross income as a qualified transportation fringe benefit within the meaning of § 132(a)(5) without requiring the employees to substantiate their use of the smartcards. The value of the fare media is also excluded from wages for FICA, FUTA, and income tax withholding.

The facts are modified slightly the second situation, cited below:

> **Situation 2.** Employer B provides to its employees transportation benefits in an amount not exceeding the statutory monthly limit. Debit card provider P provides terminal-restricted debit cards that may be used by employers to provide transportation benefits to their employees. Terminal-restricted debit cards are debit cards that are restricted for use only at merchant terminals at points of sale at which only fare media for local transit systems is sold. B uses the terminal-restricted debit cards provided by P to provide transportation benefits to its employees. B makes monthly payments to P on behalf of its employees who participate in the transportation benefit program, which P then electronically allocates to each employee's terminal-restricted debit card as instructed by B. B does not require its employees to substantiate their use of the debit cards.

The ruling also finds the value of the benefit in this arrangement may be excluded from the employee's income. The analysis holds:

> In Situation 2, the terminal-restricted debit card provided by B to its employees qualifies as a transit pass under §§ 132(f)(5)(A) and 1.1329(b) Q/A3 because it can be used only at merchant terminals at points of sale at which only fare media for local transit systems can be purchased. In addition, the amount allocated to

each employee's debit card each month is within the amount specified by § 132(f)(2)(A). Therefore, the value of the fare media provided by B to its employees through the terminal-restricted debit cards is excluded from its employees' gross income as a qualified transportation fringe benefit within the meaning of § 132(a)(5) without requiring the employees to substantiate their use of the debit cards. The value of the fare media is also excluded from wages for FICA, FUTA, and income tax withholding.

The third situation analyzes a reimbursement system that can meet the requirements for an exclusion:

Situation 3. Employer C provides to its employees transportation benefits in an amount not exceeding the statutory monthly limit. Debit card provider Q provides debit cards that may be used by employers to provide transportation benefits to their employees. Q restricts the use of the debit cards to merchants that have been assigned a merchant category code (MCC) indicating that the merchant sells fare media. The merchant may or may not sell other merchandise. C uses the MCC restricted debit card provided by Q to provide transportation benefits to its employees. A voucher or similar item exchangeable only for a transit pass is not otherwise readily available for purchase by C for direct distribution to C's employees within the meaning of § 132(f)(3).

For the first month an employee participates in the transportation benefit program, the employee pays for fare media with aftertax amounts. The employee then substantiates to C the amount of fare media expenses incurred during the month following reasonable substantiation procedures implemented by C as described in § 1.1329(b) Q/A16(c) of the Income Tax Regulations. C then remits to Q an amount equal to the amount of substantiated fare media expenses for the prior month, which Q then electronically allocates to the debit card assigned to the employee. For subsequent months, C reimburses the employee for fare media expenses incurred by the employee by providing funds to Q to be allocated to the employee's debit card equal to the amount of fare media expenses substantiated under the following procedures (not exceeding the statutory monthly limit). With respect to expenses for which employees seek reimbursement that were paid using the MCC restricted debit card, C receives periodic statements providing information on the use of each debit card, which include information on the identity of the merchants at which the debit card was used and the date and amount of the debit card transactions. In addition, for the first month the debit card was used, prior to providing reimbursement, C requires that the employee certify that the debit card was used only to purchase fare media. For subsequent months, C does not require employee certifications prior to reimbursement of recurring expenses that match the seller and the time period covered for expenses previously substantiated under the procedures described above (e.g., for an employee who purchases a transit pass every month from the same seller). However, C requires a recertification at least annually from each employee that the debit card was used only to purchase fare media. C reviews the periodic statements in combination with the employee certifications to determine the fare media expenses incurred by each employee through the use of the debit card and reimburses each employee for the expenses that have been substantiated by transmitting funds to Q to be allocated electronically to each employee's debit card. With respect to fare media expenses for which C's employees seek reimbursement that were not paid using the MCC restricted debit card, the employees substantiate the amount of the fare media expenses incurred following reasonable substantiation procedures implemented by C as described in § 1.1329(b) Q/A16(c). For example, an employee receiving reimbursements of less than the maximum monthly excludable amount of transportation expenses may increase his or her reimbursements for future months by paying for increased fare media expenses by some method other than the use of the debit card and

> substantiating the additional amount using reasonable substantiation procedures as described in § 1.132(9)(b) Q/A16(c).

The IRS analysis describes why this program is found to be a qualifying reimbursement program.

> In Situation 3,the debit card provided by C to its employees does not qualify as a transit system voucher under § 1.1329(b) Q/A16(b)(2), but C has established a bona fide reimbursement arrangement within the meaning of § 1.1329(b) Q/A16(c). The debit card provided by C does not qualify as a transit system voucher because it is possible that a MCC restricted debit card may be used to purchase items other than fare media. A merchant properly classified to accept the debit card as payment may sell merchandise other than fare media, and there is nothing in the debit card technology which prevents its use to purchase items other than fare media.
>
> Because a voucher or similar item exchangeable only for fare media is not readily available to C for direct distribution to its employees, § 132(f)(3) permits C to provide qualified transportation fringe benefits in the form of cash reimbursements for transit pass expenses, but only if the reimbursements are provided under a bona fide reimbursement arrangement. With respect to expenses incurred during the first month an employee participates in the transportation benefit program, and with respect to expenses not paid using the MCC restricted debit card, C has implemented reasonable substantiation procedures as described in § 1.1329 Q/A16(c). With respect to expenses paid using the MCC restricted debit card, C receives periodic statements providing information on the purchases made with the debit card, including the identity of the seller, and the date and amount of the debit card transactions. In addition, for the first month an employee uses the MCC restricted debit card, C requires that the employee certify that the card was used only to purchase fare media. C does not require monthly certifications with respect to recurring items if the item described in the periodic statement matches with respect to the seller and the time period that have previously been substantiated as fare media expenses. However, C requires at least an annual recertification from each employee that the debit card was used only to purchase fare media. Prior to remitting an amount to Q to put on the debit card as a reimbursement to the employee for fare media expenses, C examines the periodic statements describing debit card transactions in combination with employee certifications to determine the fare media expenses incurred by each employee through the use of the debit card. C provides funds to Q to be electronically allocated to the debit cards only as reimbursements for substantiated fare media expenses that have been incurred and substantiated in this fashion. Based on the facts and circumstances, C has established a bona fide reimbursement arrangement for transit passes within the meaning of § 1.1329 Q/A16(c). In addition, the amount of the monthly benefit is within the amount specified by § 132(f)(2)(A). Therefore, the value of the fare media provided by C to its employees through the MCC restricted debit cards is excluded from its employees' gross income as a qualified transportation fringe benefit within the meaning of § 132(a)(5). The value of the fare media is also excluded from wages for FICA, FUTA, and income tax withholding.

Presumably the IRS made this example as detailed they did to both show that specific documentation for each expense is not required but to also note the additional type of safeguards that would be necessary if the employer did not require detailed documentation for each expense.

The next situation illustrates a reimbursement system that fails to meet the requirements, and thus the value is taxable compensation to the employee. That situation holds:

> **Situation 4.** Employer D provides to its employees transportation benefits in an amount not exceeding the statutory monthly limit. Debit card provider Q provides

> debit cards that may be used by employers to provide transportation benefits to their employees. The debit cards have been restricted for use only at merchants that have been assigned an MCC indicating that the merchant sells fare media. The merchant may or may not sell other merchandise. D uses the MCC-restricted debit card provided by Q to provide transportation benefits to its employees. A voucher or similar item exchangeable only for a transit pass is not otherwise readily available for purchase by D for direct distribution to D's employees within the meaning of § 132(f)(3). D provides employees with the MCC-restricted debit cards as soon as they begin work. Prior to using the MCC-restricted debit cards, D's employees certify that the card will be used only to purchase fare media. In addition, written on each debit card is the statement that the card is to be used only for fare media, and, by using the card, the employee certifies that the card is being used only to purchase fare media. At no time do D's employees substantiate to D the amount of fare media expenses that have been incurred.

The deficiencies of this arrangement, that an employee merely "promises" not to use the card for other than transportation, are noted in the IRS's analysis:

> In Situation 4, as in Situation 3 above, the MCC-restricted debit card does not qualify as a transit system voucher under § 1.1329(b) Q/A16(b)(2). Because a voucher or similar item is not otherwise readily available to D, D may provide qualified transportation fringe benefits in the form of cash reimbursements for transit passes under a bona fide reimbursement arrangement. D provides the debit cards in advance, requiring its employees to certify that they will use the cards exclusively to purchase fare media. This arrangement does not constitute a bona fide reimbursement arrangement under § 1.1329(b) Q/A16(c) because it provides for advances rather than reimbursements and because it relies solely on employee certifications provided before the expense is incurred. Those certifications, standing alone, do not provide the substantiation of expenses incurred necessary for there to be a bona fide reimbursement arrangement. Because D is providing MCC-restricted debit cards that are not transit system vouchers, and because D is not reimbursing its employees for fare media expenses under a bona fide reimbursement arrangement, the amounts D provides to its employees through the MCC-restricted debit cards are included in its employees' gross income and are wages for FICA, FUTA, and income tax withholding.

In the fifth situation the IRS looks at the use of technological restrictions, rather than reimbursement documentation, to satisfy the requirements for an exclusion. The facts in that situation are:

> **Situation 5.** Employer E provides to its employees transportation benefits in an amount not exceeding the statutory monthly limit. Debit card provider R provides debit cards that may be used by employers to provide transportation benefits to their employees. The debit card can be used to purchase fare media on several transit systems within the metropolitan area in which E is located. The debit cards are restricted for use only at merchants that have been assigned an MCC indicating that the merchant sells fare media. The merchant may or may not sell other merchandise. R has worked with the bank that issues the debit card to place additional restrictions on the debit card based on a merchant's Merchant Identification Number. These restrictions block all purchases from any merchant in the area with an acceptable MCC that sells any items other than fare media. These restrictions have been tested and effectively prohibit recipients of the debit cards from using them to

purchase any items other than fare media. E makes monthly payments to R on behalf of its employees who participate in the transportation benefit program, which R then electronically allocates to each employee's debit card as instructed by E, in an amount not to exceed the statutory monthly limit. E does not require its employees to substantiate their use of the debit cards.

The analysis notes the reasons why this arrangement is acceptable:

> In Situation 5, the MCC-restricted debit card containing additional restrictions constitutes a transit pass because the technological restrictions and limitations effectively prohibit employees from using the cards to purchase any items other than fare media for use on local transit systems. The determining factor for a debit card to qualify as a transit pass under §§ 132(f)(5)(A) and 1.1329(b) Q/A3 is whether the card restricts purchases to fare media. Based on technological advances, this restriction can be implemented with either a terminal-restricted debit card or an MCC-restricted debit card through technologies that limit use of the card to purchase of only fare media. For example, MCC-restricted debit cards that can only be used to purchase fare media from merchants that either sell only fare media or that have a dedicated fare media terminal can qualify as transit passes because the restrictions prevent use of the debit cards to purchase items other than fare media. It is possible that other technological restrictions are or will become available that will allow additional electronic media to qualify as a transit pass. The value of the fare media provided by E to its employees through the MCC-restricted debit cards is excluded from its employees' income as a qualified transportation fringe benefit within the meaning of § 132(f) (5) without requiring the employees to substantiate the use of the debit card. The value of the fare media is also excluded from wages for FICA, FUTA, and income tax withholding

Note that the IRS indicated that this is merely an example of a sufficient technological restriction and thus the example is not meant to be the only technological safeguards that can qualify, but rather indicate the criteria to be used to evaluate whether such safeguards are sufficient.

Situation 6 analyzes delivery charges. The facts in that case are:

> **Situation 6.** Same facts as in Situation 5, except E also provides the R debit card to employees who commute using commuter highway vehicles (often called "vanpools"). E requires the employees to use the debit card to purchase their vanpool vouchers. The vanpool voucher provider does not sell any other merchandise. Vanpool vouchers may be purchased by the employee in-person at certain locations or online. If purchased online, the vanpool voucher provider imposes a reasonable and customary delivery charge. The employee includes the delivery charge as a cost of transit and pays for the delivery charge with the debit card. The aggregate cost of the vanpool voucher and the related delivery charge does not exceed the statutory monthly limit.

As the IRS notes, this case only qualifies for an exclusion. The analysis holds:

> In Situation 6, the R debit card provided by E to its employees qualifies as a transit pass under §§ 132(f)(5)(A) and 1.1329(b) Q/A3. For those employees who obtain the transit pass online, thereby incurring a delivery charge, the delivery charge is included as part of the transit benefit, and may be excluded from income, subject to the monthly statutory limit. Thus, delivery charges incurred by an employee in acquiring transit benefits are included as part of the transit benefit. In contrast, delivery charges incurred by an employer in obtaining transit passes are not taken into account in determining whether vouchers are readily available for direct distribution by an employer, as described in § 1.1329 Q/A 16(b)(5).

Situation 7 poses a case of two employers who employ the same system except for one issue. As the situation notes:

> **Situation 7**. Employer F and Employer G provide to their employees transportation benefits in amounts not exceeding the statutory monthly limit. F's employees and G's employees commute using Transit System Z. Z provides a smart-card that may be used by employers to provide transportation benefits to their employees. Z's smart-card includes separate accounts to separately track funds provided directly by an employer that are available only for transit use, funds provided directly by an employer that are only available for non-transit use (e.g., parking), and funds added by the cardholder/employee that are available for either use. Funds in each of the three accounts cannot be transferred between accounts. Debit card provider S provides debit cards, which may be used by employers to provide transportation benefits to their employees. Similar to Situation 5, the debit cards are restricted for use only at merchants that have been assigned an MCC indicating that the merchant sells fare media and the cards contain restrictions based on a merchant's Merchant Identification Number. Except as provided below, these restrictions block all purchases from any merchant in the area with an acceptable MCC that sells any items other than fare media.
>
> F provides its employees who use Z with the S debit card and employees use the debit card to load funds onto the smart-card. When F's employees use the S debit card to load funds onto their smart-cards, the funds are placed into the account holding funds that are available for either transit or non-transit use. Although the S debit card is otherwise equipped with restrictions to prevent use of the card to purchase any items other than fare media, the restrictions do not work to prevent the employee loading funds onto the smart-card account holding funds that are available for either transit or non-transit use. F does not require its employees to substantiate their use of the debit card.
>
> By contrast, G provides transportation benefit amounts directly to Z. Each month, Z places an amount not exceeding the statutory monthly limit into each of G's employees' smart-card accounts that can only be used for transit. G does not require its employees to substantiate their use of the smart-card.

The IRS finds the first program unacceptable, but determines the second one does meet the criteria for exclusion. The IRS notes:

> In Situation 7, the smart-card provided by Z qualifies as a transit pass under §§ 132(f)(5)(A) and 1.1329(b) Q/A3 with regard to the amounts provided by G directly to Z and placed into the account that can only be used for transit. In that case, the value of the fare media is excluded from the employee's income and is excluded from wages for FICA, FUTA, and income tax withholding. However, the S MCC-restricted debit card provided by F to its employees who use Z does not qualify as a transit pass under §§ 132(f)(5)(A) and 1.1329(b) Q/A3 because the debit card may be used to purchase items other than fare media. Specifically, employees that use the S debit cards to load funds onto the smart-card will be able to use those funds for either transit or non-transit use. In addition, because the smart-card qualifies as a transit pass when amounts are provided directly by the employer to Z and placed into the account that can only be used for transit, F and G must use the smart-card in this manner, or another transit system voucher, to provide transit benefits to their employees as long as the smart-card or other transit system voucher is readily available (that is, benefits provided through the S MCC-restricted debit cards could not in such case be excluded from employees' gross income as qualified transportation fringe benefits even if employees were required to, and did, substantiate that the cards were used solely to purchase fare media). Accordingly, the value of the benefits provided by F to its employees through the S debit cards is included in the employees' income and is included in wages for FICA, FUTA, and income tax withholding.

In the final situation, the IRS outlines a change in the rules that takes effect with this Revenue Ruling. Previously, if only a terminal-restricted debit card was available, an employer could elect not to use that system and instead reimburse employees. That is no longer the case and, effective for periods beginning after December 31, 2015, the employer may no longer disregard such a card when determining if there is a "readily available" voucher.

The facts of the situation are:

> **Situation 8.** Employer H has been providing transit benefits to its employees via a bona fide cash reimbursement arrangement. Debit card provider T offers a terminal-restricted debit card, which is readily available under § 1.1329(b) Q/A 16(b)(4), for use in the geographic area of H's business. T's terminal-restricted debit card is the only readily available voucher or similar item in the area.

The analysis provides the revised result:

> In Situation 8, H has implemented a bona fide cash reimbursement arrangement. However, § 132(f)(3) provides that a qualified transportation fringe includes a cash reimbursement by an employer to an employee for transit benefits only if a voucher or similar item that may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee. Rev. Rul. 200657 provided that the IRS would not challenge the ability of employers to provide qualified transportation fringes in the form of cash reimbursement for transit passes when the only available voucher or similar item is a terminal-restricted debit card. Based on comments received in response to Notice 201238, the IRS concludes that terminal-restricted debit cards are now widely used and generally available for purchase by employers subject to terms and costs that are similar to other forms of electronic media.
>
> Accordingly, the provision included in Rev. Rul. 200657 permitting employers to use cash reimbursement if the only available voucher or similar item is a terminal-restricted debit card is no longer warranted. Beginning after December 31, 2015, in order to provide time for employers to comply, employers are no longer permitted to provide qualified transportation fringe benefits in the form of cash reimbursement in geographic areas where a terminal-restricted debit card is readily available. Whether terminal-restricted debit cards are readily available for direct distribution by an employer to employees must be determined under the standards in § 1.1329(b) Q/A16(b)(5) and (b)(6).
>
> The terminal-restricted debit cards offered by T qualify as a transit pass and are readily available in H's geographic area. Therefore, beginning after December 31, 2015, H may no longer provide qualified transportation fringe benefits in the form of cash reimbursement for transit passes.

Section: 132
Differences Between Employer Operated Van Pool and Public/Private Van Pool Detailed for Application of 80/50 Rule for Transportation Fringe

Citation: Information Letter 2014-0028, 9/26/14

In Information Letter 2014-0028 the IRS details for a Senator's constituent the various options available for employer provided transportation fringe benefits and, specifically, whether the constituent's employer is properly interpreting the 80/50 rule found in IRC §132(f)(5)(B)(ii) as applied to the van pool benefit this employee is receiving.

The issue involves the "commuter highway vehicle" defined at IRC §132(f)(1)(A). Such a vehicle is defined as one meeting the following conditions:

- Has a seating capacity of at least 6 adults (not including the driver)
- At least 80 percent of the mileage use can reasonably be expected to be
  - for transporting employees between their residences and their place of employment, and
  - used on trips during which the number of employees transported for such purposes is at least 50 percent of the adult seating capacity (not including the driver) [Code section 132(f)(5)(B)].

Thus the reference to the "80/50 rule" found in the letter.

The letter first points out that the rule does not require the *employee* to use the van pool more than 50% of the time—the test solely relates to the vehicle itself.

The commuter highway vehicle rule applies to a vehicle operated by or for the employer.

Other types of qualified transportation fringes include paying for transportation for the employee provided by any person in the business of transporting individuals for compensation so long as the vehicle involved has a seating capacity of at least 6 adults not including the driver. This exclusion is the "transit pass" exclusion found at IRC §132(f)(1)(B).

The key issue boils down to which one of the two benefits is being given, which looks at whether the vehicle is operated by or for the employer. If the vehicle meets that test, then the 80/50 rule applies. If the vehicle is instead one not so operated, then the 80/50 rule would not apply. In both cases the 6 person rule would apply to the vehicle.

The IRS describes each of the options in the letter as follows:

- In an employer-operated van pool, the employer either purchases or leases vans to enable employees to commute together to the employer's place of business or he employer contracts with and pays a third party to provide the vans and pays some or all of the costs of operating the vans. If an employer-operated van meets the definition of a commuter highway vehicle, then the value (up to the statutory monthly limit) of an employer-operated van pool used by an employee is a nontaxable qualified transportation fringe [Treasury Regulation section 1.132-9(b) Q/A-21(b)].
- In an employee-operated van pool, the employees, independent of their employer, operate a van to commute to their places of employment. If the van meets the definition of a commuter highway vehicle, then the employer's cash reimbursement to employees for expenses incurred in connection with an employee-operated van pool (up to the statutory monthly limit) is a nontaxable qualified transportation fringe [Treasury Regulation section 1.132-9(b) Q/A-21(c)]. The substantiation rules for cash reimbursements found in Treasury regulation 1.132-9(b) Q/A-16(c) apply.
- In a private or public transit-operated van pool, public transit authorities or a person in the business of transporting persons for compensation or hire owns or operates the van pool. The van must seat at least 6 adults (not including the driver). The 80/50 rule does not apply to private or public transit-operated van pools. The qualified transportation benefit exclusion for transit passes is available for passes, tokens, farecards, vouchers, or similar items entitling a person to transportation in private or public transit-operated van pools [Treasury regulation section 1.132-9(b) Q/A-21(d)]. An employer must distribute transit passes for van pool transportation in a private or public transit-

operated van pool instead of providing cash reimbursements if transit passes are readily available for direct distribution by the employer to employees [Section 132(f)(3)]. Employer-provided transit passes for each month with a value not more than the statutory monthly limit do not require any certification from the employee regarding the use of the transit passes [Treasury regulation section 1.132-9(b) Q/A-18]. If an employer provides cash reimbursements, the special rules for cash reimbursement, including the substantiation requirements for cash reimbursements, apply [Treasury regulation section 1.132-9(b) Q/A-21(d)].

The first two cases are governed by the commuter highway vehicle rules—which includes the 80/50 rule. The final case is not governed by the 80/50 rule.

Section: 132
Entire Cost of Employer Paid Dependent Life Insurance With Face in Excess of $2,000 Includable as Income

Citation: Chief Counsel Email 201350037, 12/13/13

Under Notice 89-110 up to $2,000 of life insurance benefits provided to an employee on a dependent or spouse is considered a de minimis fringe benefit under IRC §132(e) so long as the benefit so long as the face amount does not exceed that amount. However, what if an employer provided the employee with $2,001 of face value on the policy—can the cost of the first $2,000 of benefits be excluded and the employee only taxed on the cost of $1.

In Chief Counsel Email 201350037 (http://www.irs.gov/pub/irs-wd/1350037.pdf) the IRS Chief Counsel's office points out that under Reg. §1.132-6(d)(4) once the benefit exceeds the deemed de minimis amount, the entire value becomes taxable, and not just the excess amount.

Section: 132
Bike Share Program Payments Are Not an Excludable Fringe Benefit

Citation: IRS Information Letter 2013-0032, 10/18/13

The IRS indicated that an employer's payment of an employee's costs to participate in a bike share program are not excludable from income either as payment of a mass transit pass under IRC §132(f)(5)(A) or as a qualified bicycle commuting reimbursement under §132(f)(5)(F). [IRC Information Letter 2013-0032, http://www.irs.gov/pub/irs-wd/13-0032.pdf]

Generally under a "bike share" program a person has the right to use an available bicycle by picking it up at a locked bicycle rack, and riding the bicycle to another location where the bicycle is again locked up on a rack maintained by the program. The person does not own a particular bike, nor does he/she obtain exclusive use of a particular bicycle.

The IRS held that such a program is not a mass transit program. While the letter doesn't indicate how the IRS arrived at this view, most likely the problem is that it is not like a train or bus where multiple people move down a shared route, but rather more like a rental car option where a person simply picks up a car from the rental company and then later drops off the same car at a rental facility.

The IRS also found that the program failed as a bicycle commuting reimbursement, since such a program is limited to payments for the purchase of a bicycle, bicycle repair or storage. In this case the individual does not own a bicycle, but rather simply obtains temporary use of a bicycle.

The IRS suggests that to be able to include such programs as an excludable fringe benefit, Congress would need to modify the law to address this issue.

Section: 162
Sponsorship of Coporation Shareholder's Son's Motocross Activity Found to Be a Reasonable Business Expense

Citation: Evans v. Commissioner, TC Memo 2014-237, 11/20/14

The Tax Court agreed with a taxpayer that the payment of expenses related to the owner's son's motocross activity was a legitimate ordinary and necessary promotional expense of the business in the case of *Evans v. Commissioner*, TC Memo 2014-237.

The business in question was a construction company in Boise, Idaho that operated as an S corporation. Each of the taxpayer's children had bee involved in motocross, but one son in particular (Ben) proved very adept at racing. In 2005 his racing career began to take off.

As the Court noted:

> At this point Mr. Evans realized that his son's talent and "star power" might help to boost DEC's business. He consulted with his certified professional accountant (C.P.A.), Bill Anderson, who advised him that supporting Ben's motocross racing could be a valid promotional activity for DEC. DEC subsequently became one of Ben's sponsors.

The Company thus began to be one of Ben's sponsors, though he other corporate sponsors. Although all of the taxpayers' other children had participated in motocross, the Company only paid to sponsor Ben's activities after he became successful.

Over time the corporation would purchase a motorhome for which it claimed an expensing deduction under §179. In 2006 and 2007 the corporation had claimed at least "$86,619 and $74,579" of expenses related to such activities, along with much lower amounts of income.

The IRS objected to these deductions, claiming they were primarily personal, lacked a business purpose and were unreasonable.

The Court found that, in fact, the business derived substantial benefits from Ben's activities and the funds used to enable those activities to move forward. As the Court pointed out:

> Boise's construction industry was particularly competitive during the years in issue, but sponsoring Ben helped give DEC an advantage over its competitors. Throughout Boise, Ben was well known as a motocross racer. Because many of DEC's jobs came through word of mouth, its relationship with the local community played an important role in driving business. DEC's association with Ben thus played an important role in boosting DEC's exposure and goodwill within the community.
>
> In addition to improving DEC's community relations and attracting more clients, Ben's celebrity status also helped DEC attract investors, such as Carl's Cycle Sales, for its projects. DEC's connection to Ben also helped it secure a major source of financing: Len Williams, the president of Home Federal Bank, first met Mr. Evans at a motocross race when he asked for Ben's autograph; his bank is now DEC's largest construction lender. DEC's connection to Ben also helped it to strengthen its relationships with local subcontractors, thus giving it an advantage over its competitors in securing the best local subcontractors for its projects and occasionally getting discounted rates.

The IRS objected to the §179 deduction for the motorhome, arguing that provided personal lodging for the taxpayer's son. The Tax Court rejected this view, noting:

> Respondent's argument focuses on two facts: (1) Ben and his traveling companions slept on mattresses in the back of the motorhome and (2) DEC incurred almost no lodging expenses in connection with the motocross racing activity. Respondent downplays the fact that the motorhome was Ben's primary means of transporting himself and his motorcycles to races until DEC purchased the Mirage trailer. We also note that, unlike most motorhomes, petitioners' motorhome had a rear wall that folded down at the push of a button to make a ramp that Ben used to roll motorcycles up into the motorhome for transport and repairs. We find that the motorhome was not used predominantly for lodging. Accordingly, petitioners were entitled to deduct its cost under section 179.

Thus, the Court found that the taxpayers had paid reasonable, business related expenses for the Son's motocross.

Section: 162
IRS Finalizes Liberalized Regulations on Reimbursements for Local Travel Expenses

Citation: TD 9696, 9/30/14

In TD 9696 the IRS finalized regulations (Reg. §1.162-32, Reg. §1.262-1) that adopted with few changes proposed regulations issued in 2012 (which taxpayers were allowed to rely upon pending the issuance of final regulations) to liberalize rules that allow, in limited circumstances, for the deduction of non-away-from-home expenses by the employer when paid for employees without treating them as income of the employee.

Qualified payments in such circumstances may qualify as working condition fringes under Reg. §1.132-5(a) if paid directly by the employer, or as an allowable reimbursement under a properly structured accountable reimbursement plan pursuant to Reg. §1.62-2(c)(4).

Reg. §1.162-32(a) provides a "facts and circumstances" test to determine if local lodging expenses represent a legitimate expense of the employer and, thus, could qualify as a working condition fringe or a proper excludable reimbursement. The regulation notes that "[e]xpenses paid or incurred for lodging of an individual who is not traveling away from home (local lodging) generally are personal, living, or family expenses that are nondeductible by the individual under section 262(a)."

However the regulations goes on to note that some exceptions will be allowed to that treatment if it can be shown the payment properly relates to the taxpayer's trade or business, based on all relevant facts and circumstances.

Specifically the regulation provides "[o]ne factor is whether the taxpayer incurs an expense because of a bona fide condition or requirement of employment imposed by the taxpayer's employer." Interestingly enough, this is the only "example" factor given in the facts and circumstances section, meaning that advisers may find examining agents will focus solely on this factor.

Conversely, the regulation notes that "[e]xpenses paid or incurred for local lodging that is lavish or extravagant under the circumstances or that primarily provides an individual with a social or personal benefit are not incurred in carrying on a taxpayer's trade or business." Advisers should be ready to deal with agent complaints that a payment or reimbursement falls into these categories, as the wording of the regulation strongly suggests that such a finding would result in automatic disallowance of the deduction.

As an alternative to the "facts and circumstances test" (which the author believes may prove difficult to have an agent concede has been met on exam) the regulation offers a safe harbor test. From a practical standpoint, advisers should counsel client that, if at all possible, they should try and arrange their affairs to meet the safe harbor if they wish to be able to pay the expense and have it excluded from employees' income.

The safe harbor imposes the following four conditions:

- The lodging is necessary for the individual to participate fully in or be available for a bona fide business meeting, conference, training activity, or other business function;
- The lodging is for a period that does not exceed five calendar days and does not recur more frequently than once per calendar quarter;
- If the individual is an employee, the employee's employer requires the employee to remain at the activity or function overnight; and
- The lodging is not lavish or extravagant under the circumstances and does not provide any significant element of personal pleasure, recreation, or benefit. [Reg. §1.162-32(b)]

The employer should be sure to document the first, third and fourth conditions (which involve some subjective elements) and be sure to not violate the purely objective "days" second test.

The regulation ends with six detailed examples the employer should study to understand how the IRS views "proper" and "improper" expenses.

Section: 162
Insufficient Funds in Bank Account Found to Block Deduction of Bonus Paid to Officer Who Endorsed Check Back to Corporation

Citation: Vanney Associates, Inc. v. Commissioner, TC Memo 2014-184, 9/11/14

Year end tax planning often leads to payments of bonuses to owners of C corporations. While that opens up issues of reasonable compensation in many cases, that's not the issue in this case.

Rather this case (*Vanney Associates, Inc. v. Commissioner*, TC Memo 2014-184) involved an architect whose corporation simply did not have sufficient cash to pay the bonus (which amounted to $815,000).

To remedy the situation the corporation (a cash basis corporation) wrote a check to Mr. Vanney which, after deducting taxes, netted to $464,183. Mr. Vanney then endorsed the check and made it payable to the corporation. Mr. Vanney never attempted to deposit the check in question. The amount was recorded as a loan from Mr. Vanney and the loan was eventually repaid during the following year.

The IRS pointed out that the company did not have sufficient funds available at the time the check was written for that check to have been cashed, the company having less than $390,000 in its bank accounts at that time and, after adjusting for outstanding checks and deposits, the actual balance was under $285,000.

The taxpayer admitted he knew the company did not have sufficient funds to have the check honored, but argued the company could have obtained a loan that would have allowed for the payment of the bonus. He decided not to do so because he didn't need the money and wanted to avoid the costs that would have been incurred in obtaining such a loan.

The IRS disallowed the bonus as a deduction, arguing that no payment actually took place. The Tax Court agreed, noting that deduction of a payment may be disallowed if there were insufficient funds available to honor the check when issued or the recipient holds the check beyond the taxpayers' year end due to knowledge the payor has insufficient funds to cover the check.

Although the court did not address the issue, it seems likely that if the owner had actually loaned cash to the corporation (bringing the balance up above the balance needed to pay the check) and then actually cashed the check that the result may have been different. This is assuming the officer had sufficient personal funds to actually make that loan (he/she doesn't need the bonus to make the loan) and the funds are actually deposited.

However, simply writing a check and then endorsing it back to the paying corporation clearly was rejected by the Tax Court as an option for obtaining recognition of a bonus. Rather the Court decided to recognize the bonus as paid when the "loan" was actually paid off in the following year.

Section: 162
Commission of European Community is a Government Agency or Instrumentality, No Deductions Allowed for Its Fines

Citation: Guardian Industries, Inc. v. Commissioner, 143 TC No. 1, 7/17/14

The Tax Court decided that fines paid to the Commission of the European Community are amounts paid to a government and thus barred from deduction under IRC §162(h) in the case of *Guardian Industries, Inc. v. Commissioner*, 143 TC No. 1, http://www.ustaxcourt.gov/InOpHistoric/GuardianIndustriesCorp.Div.Lauber.TC.WPD.pdf.

The Commission had found that the Company and its subsidiaries had engaged in price fixing and imposed a €148 fine. The Company, claiming the payment wasn't made to a government, claimed a deduction for the payment as an "ordinary and necessary business expense."

The Tax Court analyzed a number of factors and concluded the agency was an instrumentality. The Court looked to factors enumerated by the Second Circuit Court of Appeals in the case of *Filler* (*Filler v. Hanvit Bank*, 378 F.3d 213, 217 (2d Cir. 2004)) to determine if an entity is an agency or instrumentality of a government. Those factors the Court looked at were:

> (1) whether the foreign state created the entity for a national purpose;
>
> (2) whether the foreign state actively supervises the entity;
>
> (3) whether the foreign state requires the hiring of public employees and pays their salaries;
>
> (4) whether the entity holds exclusive rights to some right in the [foreign country]; and
>
> (5) how the entity is treated under foreign state law.

The Court, looking at the first test, noted:

> The first factor is whether a foreign state or foreign states "created the entity for a national purpose." This inquiry closely resembles the inquiry we have made as to whether the Commission "performs an important government function." The Court of Appeals in *RJR Nabisco*, 2014 WL 1613878, at *12, deemed it "beyond doubt" that the member states founded the EC "for a 'national purpose.'" The first Filler factor, which we believe to be the most important for purposes of section 162(f), thus furnishes strong support for the conclusion that the Commission is an "agency or instrumentality" of the EC member states.

With regard to the second factor, the Court found:

> For reasons adequate to themselves, the member states have chosen to exercise their supervisory authority over the EC and the Commission through a consultative and collaborative, rather than an autocratic, process. In the competition arena, this supervision is "active" in the sense that the

> Commission consults regularly with numerous organs of the EC and numerous representatives of the member states, all of whom have the ability to influence its decisions. Cognizant that the second Filler factor "does not require the foreign state to micro manage every aspect of the organ's activities," RJR Nabisco, 2014 WL 1613878, at *13, we conclude that the "active supervision" factor slightly favors the Commission or is neutral here.

On the third factor the Corut found:

> The Court of Appeals concluded that the formal arrangements used to pay diplomatic salaries are "of small importance at best," 2014 WL 1613878, at *13, and we agree with that conclusion. If we were considering whether the Commission were an "agency or instrumentality" of a single foreign government, whether that government formally employed its officers might be a salient factor. Cf. Glencore, Ltd. v. Chase Manhattan Bank, N.A, No. 92-civ6214, 1998 WL 74294, at *3 (S.D.N.Y. Feb. 20, 1998) (concluding that bank officials employed by the government of India were "public employees" under the FSIA). But these formal employment details seem insignificant in the present context, where we are considering whether a penalty imposed by an entity created by multiple sovereigns qualifies for a tax deduction. The salient fact is that Commission officials are public employees who exercise powers conferred by public law, including the power to impose penalties backed by the sanction of government. Like the Court of Appeals in RJR Nabisco, we regard the third Filler factor as basically neutral here and in any event as a factor that should be given little weight

The Court finds the fourth factor clearly favors the IRS position as it notes:

> The fourth factor is whether the entity "holds exclusive rights to some right in the foreign country." The Court of Appeals in RJR Nabisco, 2014 WL 1613878, at *13, concluded that the EC holds "the exclusive right to exercise a number of significant governmental powers" in the EC member states, including the right to "authorize the issue of banknotes within the Community" and "to conclude the Multilateral Agreements on Trade in Goods." With respect to competition law specifically, the Commission has the right to conduct investigations of anticompetitive behavior within member states and to record an infringement for competition violations. This factor favors finding that the EC is an "instrumentality" of the member states.

The Court also sees the fifth factor as favoring the IRS, noting:

> Petitioner argues that the member states do not regard the Commission as an "agency or instrumentality" below them but as a supranational body that is in some sense above them. The Court of Appeals answered this argument succinctly:
>
>> This argument * * * depends on the proposition that a governmental entity created by a collectivity of governments * * * cannot be at once a supranational entity and an organ or agency of the actors that created it. It appears to us that both descriptions are accurate, and the fact that the * * * [EC] functions as a supranational governmental entity does not negate its also being an organ and agency of its member states, which continue to exist as sovereign nations, notwithstanding having delegated some of their governmental powers to the supranational agency they created.
>
> 2014 WL 1613878, at *14. We agree with this analysis and conclude that the fifth Filler factor supports the conclusion that the Commission, as the executive branch of the EC, is an "agency or instrumentality" of its member states.

Thus the Court, looking at the factors, conclude they clearly lead to the finding that the Commission is an agency or instrumentality of a government, and thus no deduction is allowed due to the limitations under] IRC §162(h) for such amounts.

Section: 162
Bank and Supply Store Where Taxpayer Was Merely a Customer WIll Not Be a Regular Business Location for Auto Expenses

Citation: Bogue v. Commissioner, TC Memo 2011-164, affd CA3, 111 AFTR 2d, cert denied 3/31/14

Clients are often very upset when they discover that the tax law does not generally provide for deductions for auto expenses that are considered commuting to or from a taxpayer's work location. Rather only travel between work locations generally qualifies for a deduction.

In the 1993 *Walker* decision 101 TC 537 the Tax Court had allowed a taxpayer who used his home office as a regular work location but not his principal location to treat travel to and from that as deductible, interpreting Rev. Rul. 90-23. While the IRS in Rev. Rul. 94-47 specifically declared that a home office that didn't meet the §280A standard for a deductible home office could not be a regular work location for travel, some taxpayers and their advisers reasoned that things other than a home might qualify.

That has lead some to attempt to take a broad view of what is a work location, including banks, post offices and office supply stores--but the Tax Court and the Third Circuit both agreed that, in the case of Bogue v. Commissioner, TC Memo 2011-164, http://www.ustaxcourt.gov/InOpHistoric/BOGUE2.TCM.WPD.pdf, affd CA3, 111 AFTR 2d 2013-2179, http://www2.ca3.uscourts.gov/opinarch/121508np.pdf.

The Court of Appeals rejected the use of stores and banks as "work locations" generally, noting:

> Bogue claims that he meets this exception because the bank and various building supply stores were "regular work locations" for him. The Tax Court rejected that argument, and noted that Bogue did not establish that he worked or performed services at any of those locations. ... Construing a building supply store or bank as a "regular work location" strains the meaning of "work location," as Bogue was at those locations as a customer, rather than a worker. See Rev. Rul. 90-23, 1990-1 C.B. 28 (available at 1990 WL 657156) ("a regular place of business is any location at which the taxpayer works or performs services on a regular basis").

Mr. Bogue didn't like this answer and attempted to get the U.S. Supreme Court to hear his case. However, on March 31, 2014 the U.S. Supreme Court turned down the request to hear the case.

Advisers should take note of this decision, especially if clients have been looking to "push the envelope" on deducting travel expenses by claiming to drop by a particular location (banks and post offices seem particularly popular) that just happens to be near their home on a daily basis to justify a deduction.

Rather, the Court of Appeals has adopted the view that a regular work location will only include locations where the individual is something other than a customer.

Section: 162
No Deduction for Payment Made to Terminate Agreement Made With Organization That Paid Physician's Medical School Tuition

Citation: Dargie v. United States, 113 AFTR 2d ¶ 2014-457, CA6, 2/5/14

The Sixth Circuit Court of Appeals, affirming the decision of United States District Court for the Western District of Tennessee, rejected a physician's view that amounts he repaid to a medical facility that had paid his tuition years earlier. He repaid these amounts after failing to fulfill an obligation under which he had agreed to practice in a specific community for four years.

The case in question is that of *Dargie v. United States*, 113 AFTR 2d ¶ 2014-457, CA6 (http://www.ca6.uscourts.gov/opinions.pdf/14a0027p-06.pdf). Dr. Dargie had his tuition and expenses while in medical school paid for by the Middle Tennessee Medical Center (MTMC). His agreement with MTMC provided that the debt would be forgiven if he worked for four years in a specific underserved community in Tennessee. If he failed to do so, Dr. Dargie would be obligated to repay two times the entire amount that had been advanced or an amount that he and MTMC agreed upon.

Dr. Dargie apparently had a change of heart about working in the specific underserved community and, upon starting to practice, decided to practice instead near Memphis. He and MTMC agreed that he would repay the amount of the advance plus an amount for interest.

The doctor attempted to claim the payment as a business deduction. He argued that the amount was simply a settlement of a damages claim with MTMC, a payment made simply to enable him to locate his business in his preferred location rather than the originally agreed upon location. Thus, he argued, it was simply an ordinary and necessary expense of his medical practice.

The Sixth Circuit, in a published opinion, found the view of the IRS and the District Court more reasonable. The Court, citing the Supreme Court's opinion in *United States v. Gilmore*, 372 US 39, found that in order to determine whether an expense is a nondeductible personal expense or a business expense, the issue of the origin of the claim rather than potential future consequences to the taxpayer must be considered.

In this case the claim arose from Dr. Dargie's expenses incurred for his medical education necessary to meet the minimum requirements to practice as a physician. Such expenses are specifically held to be non-deductible by Reg. § 1.162-5(b)(2). The fact that the payment might enable Dr. Dargie to obtain a future business benefit and that he made a business decision to pay the penalty rather than fulfill the agreement is not relevant.

Section: 162
No Trade or Business Established by Recent Graduate, Thus No Basis for Deducting Expenses Related to MBA

Citation: Hart v. Commissioner, TC Memo 2013-289, 12/23/13

Many disputes have arisen between the IRS and taxpayers when taxpayers attempt to claim a deduction for the cost of obtaining an MBA degree. The issue arose again in the case of *Hart v. Commissioner*, TC Memo 2013-289, http://www.ustaxcourt.gov/InOpHistoric/HartMemo.Kerrigan.TCM.WPD.pdf.

Normally the question turns on whether or not the taxpayer's education expenses qualify under Reg. §1.162-5(a) and (b) which generally requires, in order for education expenses to be deductible, that

- The expense maintains or improves the skills required by the taxpayer in his/her trade or business *or*
- Meets the express requirements of the individual's employer or applications of a law or regulation that makes obtaining the education a condition for retention of the position.

But the education expense is not deductible, even if it meets the above criteria, if the education is part of a course of study that leads to the taxpayer qualifying for a new trade or business. This last criterion is one that often leads to conflict, specifically in the MBA cases.

But this case turned on a different question—in order to maintain the taxpayer's skills in his/her trade or business, the taxpayer must have established a trade or business. The IRS contended in this case that the taxpayer had not done so.

The taxpayer in question had graduated from college in 2007, and enrolled in the MBA program during January of 2009. The Tax Court outlined his employment as follows:

> From January 1 to approximately April 30, 2009, petitioner husband was an employee of Priority Healthcare Distribution. He was unemployed from approximately May 1 to August 10, 2009. From August 11 to October 1, 2009, he worked for ADP Totalsource as an account manager. From October 2 to 11, 2009, petitioner husband was unemployed. On October 12, 2009, petitioner husband began working as an entry-level professional for Walgreen Co

The taxpayer contended he was in the business of selling cancer pharmaceuticals, a specialized field.

While had had started employment in the field before beginning the MBA program, it was not very long before his enrollment (in fact, in the same month). That position lasted only four months, and then he was unemployed for over three months. He then took a position that lasted less than two months. While he contended that his work on those two jobs were related to his specialty, the Tax Court noted that he did not link is work at Walgreen's to this specialty.

Working in the field only a few months, and most of that after enrolling in the MBA program, failed to meet the requirement that either he had established a trade or business of selling cancer pharmaceuticals or that he did so before enrolling in the educational program. Since either of those failures would be fatal to the deduction, the Court did not have to look at whether the MBA qualified him for a new trade or business.

Section: 162
Current Deduction Allowed for Insurance Company Payment to Fund to Pay Benefits to Customers of Failed Insurance Company

Citation: PLR 201343003, 11/1/13

Can voluntary payment of expenses for an unrelated business be deductible? They can if the payment is solely to preserve the taxpayer's own goodwill, an issue addressed in PLR 201343003 (http://www.irs.gov/pub/irs-wd/1343003.pdf).

In this situation a life insurance company operating in a state was found to have insufficient funds to pay benefits as they came due. Thus, beneficiaries would face reduced benefit payouts due to the failure of this insurer.

Such a situation could prove a problem for other insurers, since it would serve to reduce confidence in the industry in general. The state in question set up a Fund to which insurers could voluntarily contribute amounts that would be used to pay benefits that could not be paid by the failing company. The ruling asked if such payments could be deductible as ordinary and necessary business expenses.

The IRS ruled that payments that serve solely to protect a taxpayer's existing goodwill and which do not result in creation of a capital asset are currently deductible, and that these payments met those criteria. The IRS ruled, as well, that they represented a liability for which specific economic performance rules are not provided for elsewhere in the regulations, thus under Reg. §1.461- 4(g)(7) the amount was deductible when paid.

The IRS pointed to prior Revenue Rulings addressing similar situations. In Revenue Ruling 73-113 an entity advanced funds to the city to clean up an oil spill that was costing it tourist business and in Revenue Ruling 76-203 a warehouse operator paid for uninsured customers of its warehouse. In both cases the companies were acting to protect their goodwill and not to create a new capital asset.

Section: 162
Despite Claimed "Unique" Situation, No Deduction Allowed for Commuting Expenses

Citation: Cor v. Commissioner, TC Memo 2013-240, 10/22/13

The fact that the taxpayer endured a long commute to a remote location without access to public transportation nor, apparently, any nearby housing did not turn commuting into a deductible employee business expense. The Tax Court gave this result to the taxpayer in the case of Cor v. Commissioner, TC Memo 2013-240, http://www.ustaxcourt.gov/InOpHistoric/CorMemo.COHEN.TCM.WPD.pdf. '

The taxpayer had to commute to remote test site in the Nevada desert, requiring a 160-mile daily commute. The taxpayer argued the unique nature of this commute should override the normal rule that commuting expenses are treated as personal, nondeductible expenses.

The Tax Court noted that this taxpayer was not the first to attempt this argument with regard to this site. In 1976, the same issue was decided in the case of Coombs v. Commissioner, 67 T.C. 426 (1976), aff'd in part, rev'd in part on other grounds, 608 F.2d 1269 (9th Cir. 1979). The facts here were virtually undistinguishable from those in the Coombs case, and the result is the same.

Effectively the Court is telling taxpayers that commuting expenses will not be allowed as a tax deduction, regardless of the unique facts of their situation, if the expenses do not meet one of the generally allowed exceptions to this prohibition (such as travel to a distant temporary work location).

Section: 162
Tax Preparer's Expenses to Hide from Her Clients "So She Could Function" Not Found to be Deductible Business Expenses

Citation: Linzy v. Commissioner, TC Memo 2013-219, 9/16/13

A tax preparer's creativity in deciding what was an "ordinary and necessary" business expense and solving a practice problem she hadn't anticipated was, unfortunately, not rewarded by the Tax Court with an allowable deduction in the case of Linzy v. Commissioner, TC Memo 2013-219, http://www.ustaxcourt.gov/InOpHistoric/LinzyMemoKerriganFinal.TCM.WPD.pdf.

Ms. Linzy had a number of tax deductions before the court, but the most interesting (or perhaps amusing) was her justification for claiming certain travel expenses.

Ms. Linzy was operating her tax preparation business out of her home, opening her business after having worked for two different franchised tax preparation businesses. Unfortunately Ms. Linzy discovered there was one factor she had not appropriately considered when decided to go on her own and run her practice from her home—her clients now knew where she lived and had her home number.

Armed with such knowledge, clients would bother Ms. Linzy at all hours of the day and night with various issues that needed to be dealt with "right now"—at least in the client's view.

Ms. Linzy came up with a solution to this problem. As the Court described it:

> With respect to her travel expenses petitioner testified that she ran Joyce's Tax Service from her home and that clients would come to her property to have their tax returns prepared. Petitioner testified that living in her neighborhood was stressful and that she felt harassed by her clients who would call her at home at any hour. For these reasons petitioner contends that it was necessary for her to travel "just to get rest so that * * * [she] could function." She provided invoices from a Holiday Inn, a car rental service, and a casino.

While Joyce gets points for creative thinking, she does not obtain a tax deduction. The Court, in denying her deduction, noted: "A taxpayer's choice about where to live is personal." The Court therefore held "...petitioner's travel for a good night's rest was a personal expense, not a deductible business expense."

The key flaw in this case is that her justification was principally related to personal, and not business, issues. Under IRC §262(a) "[e]xcept as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses." As well, Reg. §1.162-1(a) provides that expenses must be "…directly connected with or pertaining to the taxpayer's trade or business…"

Her need for personal space away from the office was a personal, rather than business, related issue. There was not a sufficiently direct relationship to justify the deduction.

Section: 162
Payments to Investors to Not Redeem Shares Were Deductible Until Clear Agreements Were Reasonably Expected to Be Renewed at Termination, IRS Formally Disagrees With Holding

Citation: Media Space, Inc. v. Commissioner, 135 TC No. 21, 10/18/10, AOD 2012-8, 7/19/13

Payments made by a corporation to investors to not exercise their right to force the corporation to redeem their shares were held to be deductible in part by the Tax Court in the 2010 case of Media Space v. Commissioner, 134 TC 424 (http://www.ustaxcourt.gov/InOpHistoric/MediaSpace.TC.WPD.pdf). However, in Action on Decision 2012-08 (ftp://ftp.irs.gov//pub/irs-aod/AOD%202012-08.pdf) the IRS indicated its disagreement with the Tax Court and that it continue to litigate that such expenses must always be capitalized.

In the case in question the corporation was obligated to redeem certain shares at specified dates at the shareholder's request, something it lacked the liquidity to do as the dates approached. To prevent the shareholders from exercising those rights, the corporation offered to make a payment to the shareholders in exchange for their agreement not to exercise those rights for one year.

At the end of that year the company's position had improved, but it did not have the funds right away to redeem the shares. As such, it negotiated an 8 month extension of the agreement and paid an additional sum. When that 8 month term expired the company determined that it not only did not have the liquidity to make the payment, but was unlikely to have such ability in the foreseeable future. At point additional agreements were entered into.

The Tax Court agreed with the IRS that the corporation's initial treatment of the payments as interest deductible under §163 was incorrect, holding that no liability existed until a redemption was actually requested—something the payments prevented from happening. But the Tax Court for a time agreed with the taxpayer's alternative view that the payments were deductible as ordinary trade or business expenses under §162(a).

The Tax Court found evidence was submitted that making such payments to delay a redemption was normal operating practice in the industry, making it an ordinary and necessary expense. The Court did not agree with the IRS's view that the payments represented a payment in connection with the reacquisition of its stock blocked by §162(k) since, again, no such redemption occurred. The Court also rejected the IRS's alternative view that the payment was related to a reorganization under §368, with a deduction blocked by §361(c)(1).

The Court found that while Reg. §1.263(a)-4(d)(2)(i) would generally require the payments to be capitalized, the special 12 month exception found at Reg. §1.263(a)-4(f)(1) allowed a deduction for the payment for the first period as well as the first 8 month extension. In both cases, the corporation had an expectation of being able to redeem the shares at the end of that period.

However the Court found no such reasonable expectation existed after that date, with Reg. § 1.263(a)-4(f)(5)(i) requiring the expected duration of a right include the amount of any expected renewal period. By the time the second extension was made, experience suggested clearly that it was not reasonable to assume that another extension would not be the result at the end of the latest period, requiring that the payments be capitalized.

The IRS appealed the case to the Second Court of Appeals. However, before the appeal was heard the taxpayer settled the case with the IRS and agreed to capitalize the payments related to the first payments that the Tax Court had allowed a deduction for. The Second Circuit Court of Appeals ruled that the IRS challenge was now moot, and so dismissed the case.

Nevertheless, the IRS was still faced with a published Tax Court decision that had not been overruled. The IRS argues that, in fact, the Tax Court improperly applied the regulation in question that forbearance payments in a case such as this must always been capitalized. Thus, the IRS will continue to challenge taxpayers who assert a position in line with the Media Space case.

Section: 165
Defaults on Notes Related to Sale of Business Where Seller Elected Out of Installment Method Gives Rise to Ordinary Losses, But Not a Claim of Right Situation

Citation: CCA 201328031, 7/12/13

The situation described in Chief Counsel Advice 201328031 (http://www.irs.gov/pub/irs-wd/1328031.pdf) arose from two notes received by an LLC in exchange for the sale of its assets. One note (Note A in the ruling) was for a fixed amount, while the second note (Note B) was payable up to a fixed maximum amount based on the results of operations for the following four years.

The LLC had recognized the entire gain in the year of sale, setting the amount from the second note at the maximum possible payout. The LLC then distributed all of its remaining assets, including the two notes, to its partners and terminated operations.

The buyer defaulted on Note A and the results from operations meant that no amounts were actually due and paid on Note B. The question was, given that the partnership had elected out of the installment method and the partners had recognized the maximum possible gain entirely in the year of sale, how to deal for tax purposes with the lower ultimate payout than sales proceeds originally recognized.

The advice first considered whether the claim of right recovery provisions of IRC §1341 applied to this transaction. Generally if a taxpayer has an unrestricted right to an item of income in a particular year, the income is recognized in that year even if there is contingency under which a portion or all of that item will need to be returned to another party. If the amount is excess of $3,000, the taxpayer obtains either a deduction in the year of return for the amount returned or a credit against that year's tax for the reduction in the original year's tax that would have occurred if the item had not been included in income.

The advice determined that the losses on neither note met the criteria for a §1341 claim of right. Note A was a simple bad debt, and Reg. §1.1341-1(g) provides that the claim of right provisions do not apply to a bad debt. This is because the taxpayer still has the same rights under the note—they just are no longer practically recoverable. Similarly, the taxpayer had the same rights under Note B as it had in the first year when they reported the maximum possible recovery as sales proceeds.

However, the ruling noted that the taxpayers would qualify for an ordinary loss in either case. For Note A, the situation was simply a bad debt deduction. The IRS decides that this bad debt is a trade or business bad debt, as the partner is generally regarded to be in the trade or business of the partnership.

The advice noted it wasn't clear whether note B should be treated under the same theory as Note A. If Note B was considered to be a true debt then the IRS concludes its treatment would be the same as Note A.

However, if Note B was really a contractual right to future profits, then it would be a §165 loss. Since the income recognized related to Note B was treated as ordinary income, under the doctrine outlined in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) the later deduction related to that transaction would retain its nature (ordinary in this case).

The IRS also ruled that if the losses were business losses for the purpose of calculating a net operating loss.

Section: 166
Failure to Establish a Bona Fide Debt Fatal to Taxpayer's Claimed Business Bad Debt Deduction

Citation: Dickinson v. Commissioner, TC Memo 2014 136, 7/10/14

For a taxpayer to claim a bad deduction, the taxpayer must be able to establish that an actual debt existed. In the case of *Dickinson v. Commissioner*, TC Memo 2014-136, http://www.ustaxcourt.gov/InOpHistoric/DickinsonMemo.Chiechi.TCM.WPD.pdf, the taxpayer was unable to establish the facts to allow for a bad debt deduction for a loan he claimed to have made to a business partner.

Mr. Dickinson was a self-employed consultant. In 1998 he decided to retain the services of an individual who had previously worked for him. At the time he hired this person, Mr. Dickinson was aware that the individual owed money to his former spouse and children and had a number of financial problems arising from that situation.

Nevertheless, he advanced money to this person in spite of his financial difficulties. He also did not execute a promissory note or any other evidence of the obligation aside from a note he wrote to the individual, stating "I agree to loan you money to get settled in over here, and help you out financially as long as I see our new company is working, and you are going to work as hard as you did for me the last time we worked together." He never charged the individual interest nor was any repayment schedule.

It turns out that the funds in question were not quite enough—so the employee took funds he was not authorized to withdraw from bank accounts over which Mr. Dickinson had signature authority over.

Eventually the parties went their separate ways and Mr. Dickinson now began to look for ways to get money back, filing suit against the employee. In response the employee claimed that the amounts in question were not loans. The lawsuit was still pending at the end of 2007 and in 2009 the court dismissed the lawsuit.

Mr. Dickinson claimed a business bad debt loss on his 2007 Schedule C for the amounts advanced to the employee. The IRS disallowed the deduction, setting up the case decided by the Tax Court.

The first question the Court looked at was whether or not there was a bona fide debt, since only a bona fide debt can qualify for a bad deduction. Mr. Dickinson claimed it was his usual practice to make such loans in his business and that he did not require written documents.

However, the Court indicated that the only evidence presented on that point was Mr. Dickinson's own self-serving testimony. While the Court did not expand on this view, it seems reasonable to assume that the Court would have wanted to have heard from individuals to whom Mr. Dickinson had made such loans, both to confirm it was his practice and, likely of even more interest, whether he ever actually looked for repayment of such obligations.

The Court then noted the lack of a number of objective factors that would serve to indicate an actual debt, such as a signed promissory note, collection of interest on the notes, a repayment schedule for the loans, any collateral pledged for such notes and actual repayment on the note.

As well, the Court did not believe, given the employee's significant financial difficulties at the time the loan was made, that Mr. Dickinson could have had any reasonable expectation of repayment.

While the Court did not comment on the issue, the facts suggest that Mr. Dickinson would have faced another problem even if he had shown it was a bona fide note—the fact that, as of the end of 2007, he was still pursuing collection of the debt in Court. A taxpayer need to establish the fact that there is no longer a reasonable expectation of collecting the balance of the debt and it seems likely with a claim before the Court for repayment in excess of the bad debt claimed that Mr. Dickinson would have failed this test as well.

Section: 167
Minor League Baseball Signing Bonus Must Be Amortized Over Period Player Bound to, Not Actual Average Life of Contract

Citation: FAA 201339001F, 9/27/13

A minor league baseball team must amortize signing bonuses paid to players over the term provided when a player may not play for another team, and not over the average life of contracts disposed of by the team according to the Chief Counsel's office in Field Attorney Advice 201339001F (http://www.irs.gov/pub/irs-lafa/20133901f.pdf).

Under the standard contract that was used by the team a player must play for the team in question for seven seasons unless the contract is terminated by the team—that is, generally the taxpayer must agree to any termination, which the team can do for lack of sufficient skill. Presumably the reason why most contracts fall short of seven years is due to such terminations by the team.

The team argued that, under Reg. §1.167(a)-3(a), the life of the contract should be the average life of contracts based on its history and not the seven year life. The team argued for this position by citing the case of *Rodeway Inns of America v. Commissioner*, 63 TC 414 (1974).

The IRS distinguished the facts in that case. In *Rodeway* the other party to the contract had the right to cancel at any time after 90 days notice. Eventually the parties agreed to a cancellation agreement and the court determined a useful life based on the particular facts of how long the other party most likely would have kept the contract in place had Rodeway Inns not approached them to enter into a termination arrangement.

The IRS points out that in the *Rodeway Inns* situation the taxpayer was the one with no control over the term of the agreement—had the other party not agreed to the termination, Rodeway would have been stuck with living up to the agreement until the other party either terminated the agreement or failed to exercise its renewal option.

In this case, the team was effectively the only party that could shorten the agreement. A player who simply decided to stop playing for the team was unable to play for another team until the seven period concluded. The IRS argued that the team was, for tax purposes, stuck with amortizing over the seven year period it written into the contract to bind the other party.

While an interesting case on lives of amortizable assets, advisers should note that this was not a §197 intangible acquired as part of a business. In those cases a statutory life (normally 15 years) must be used. For instance, an agreement not to compete that is acquired in connection with the acquisition of a trade or business (directly or indirectly) is a §197 intangible. [IRC §197(d)(2)(E)]

But for intangible assets that are not subject to the §197 rules, the analysis does provide some guidance on what the IRS viewed as considerations that are important in determining the life.

Section: 168
IRS Issues Last Set of Final Regulations from Tangible Property Project Related to Group Asset Accounts and Automatic Accounting Method Change Revenue Procedure

Citation: TD 9689, 8/18/14, Revenue Procedure 2014-54, 9/18/14

The IRS has issued the last portion of the "repair" regulations, finalizing the rules for general asset accounts under §168(i) in TD 9689 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-19403.pdf).

The final regulations generally follow the provisions found in the 2013 proposed regulations issued at the same time as all other final regulations that were part of the tangible asset/repairs project (TD 9636, 9/19/13).

Only minor changes were made to the proposed regulations issued in 2013. One set of changes related to dispositions involving demolition of structures governed by IRC §280B. The preamble describes these changes as follows:

> In the case of a loss sustained on account of the demolition of a structure to which section 280B and §1.280B-1 apply, however, the loss is capitalized to the land on which the demolished structure was located, and no gain or loss is reported at the time of demolition. Nevertheless, a taxpayer generally will report a depreciation deduction for the demolished structure for the taxable year in which the demolition occurs.

The IRS also clarified rules related to determination of the unadjusted basis when disposing of a portion of a group asset. These rules interact with the revised treatment of buildings under the capitalization regulations for §280(a) by allowing taxpayers to write off, for instance, a structural component of a building (such as a roof) when that component is replaced and required to be capitalized under Reg. §1.263(a)-2.

The preamble notes:

> The final regulations generally retain the rules in the 2013 proposed regulations on determining the unadjusted depreciable basis of an asset for which general asset account treatment is terminated. Because the general asset account is the asset, the final regulations provide that a taxpayer may use any reasonable method that is consistently applied to all assets in the same general asset account to determine the unadjusted depreciable basis of a disposed asset in that account if it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of that asset.
>
> This rule also applies when the partial disposition rule applies to a disposition of a portion of an asset included in a general asset account. The IRS and the Treasury Department expect that reasonable methods are available that use information readily available or known to the taxpayer and do not necessitate undertaking an expensive study.
>
> These final regulations also provide nonexclusive examples of reasonable methods. These examples are the same examples in the 2013 proposed regulations, except the final regulations do not include the Consumer Price Index as an example of a reasonable method for the reason previously discussed in II.E. Similar to the rules for determining the unadjusted depreciable basis of a disposed asset under §1.168(i)-8, the final regulations clarify that, when discounting the cost of the replacement asset, using the Producer Price Index for Finished Goods (or its successor, the Producer Price Index for Final Demand) is a reasonable method. The examples in the final regulations include the following: (1) discounting the cost of the replacement asset to its placed-in service year cost using the Producer Price Index for Finished Goods (or its successor, the Producer Price Index for Final Demand, or any other index designated by guidance in the Internal Revenue Bulletin (see §601.601(d)(2) of the chapter) only if the replacement asset is a restoration under §1.263(a)-3(k) and is not a betterment under §1.263(a)-3(j) or is not an adaptation to a new or different use under §1.263(a)-3(l); (2) a pro rata allocation of the unadjusted depreciable basis of the general asset account based on the replacement cost of the disposed asset and the replacement cost of all of the assets in the general asset account; and (3) a study allocating the cost of the asset to its individual components.

Approximately a month after the final regulations were issue the IRS issued Revenue Procedure 2014-54, a 93 page document that provides additional automatic accounting method change options to handle the modifications made by these final regulations. This procedure is essentially the final portion of the accounting method change provisions related to the revised tangible property repair/capitalization regulations that took effect for years beginning after December 31, 2013.

Section: 168
Zip Type Drywall Partitions Found to Be Personal and Not Real Property

Citation: PLR 201404001, 1/24/14

The IRS granted a taxpayer's request to rule that a "zip type" wall partition is personal, not real, property for purposes of depreciation in PLR 201404001 (http://www.irs.gov/pub/irs-wd/1404001.pdf).

The partition in question is a drywall partition that is designed to be removable and reused after being repositioned. As the request described it:

> The zip type drywall partition system consists of the zip type partition elements that include zip type drywall partitions (i.e., removable/reusable gypsum drywall panels finished and painted), removable

zip tape and joint compound, removable/reusable studs and tracks, and removable/reusable screws, and the zip type partition attachments that include removable/reusable panel coverings, removable/reusable base and crown trim, removable/reusable integral door units, removable/reusable internal utilities, removable/reusable integral glazing, and removable/reusable cabinets on the zip type drywall partitions. The zip type partition uses a releasable adhesive on the zip tape over the panel joint. Unlike other drywall joint tapes, a person can zip the zip tape up without the tape breaking even after the joint compound has significantly cured. When zipped up, the zip tape removes the joint compound that covers it and then exposes the screws under the zip tape in a manner that allows screw removal and then disassembly of the zip type partition for removal and re-use. A pull tab is on the zip tape to alert remodel contractors that this joint tape is the type that can be zipped up for disassembly of the partition.

> The zip type partition is designed and constructed to be movable. It can be readily removed and can remain in substantially the same condition after removal as before, or it can be moved and reused, stored, donated, or sold in its entirety. Removal of the zip type partition does not cause any substantial damage to the zip type partition itself or to the building. Taxpayer anticipates that the zip type partitions may need to be moved in order to accommodate the associated reconfigurations of the interior space within the Owned Property and Leased Property.

The IRS conditionally ruled that such partitions were personal property based on the factors found in the 1975 case of *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 which the taxpayer represented these partitions met. The Whiteco factors are:

- Is the property capable of being moved, and has it in fact been moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances that tend to show the expected or intended length of affixation, that is, are there circumstances that show the property may or will have to be moved?
- How substantial a job is removal of the property, and how time consuming is it?
- How much damage will the property sustain upon its removal?
- What is the manner of affixation of the property to the land?

Advisers should note that the factors look not only at the nature of the property but also to the taxpayer's expected use of the property. So it's not necessarily the case that all zip type partitions would qualify as personal property if the taxpayer had no intent to remove the partitions.

Section: 168
Merely Taking Business Trips on Aircraft Prior to December 31 Did Not Place Asset in Service Where Taxpayer Mandated Modifications Remained to Be Made

Citation: Brown v. Commissioner, TC Memo 2013-275, 12/3/13

The Tax Court looked at whether a taxpayer had actually placed in service an aircraft in 2003 when the taxpayer took a last minute delivery, took trips on the plane on December 31, and then had it returned to the seller for modifications that had been arranged prior to taking delivery that the taxpayer deemed essential to the use of the plan in his business. The case in question is the one of Brown v. Commissioner, TC Memo 2013-275, http://www.ustaxcourt.gov/InOpHistoric/BrownMemo.Holmes.TCM.WPD.pdf.

The taxpayer in question was a very successful insurance salesman who served the extremely well off. As the Court noted, the extremely well off aren't necessarily the most patient of potential customers, so Mr. Brown had purchased aircraft which he used to be able to attend meetings at widely dispersed geographic locations on short notice.

In 2003 he was in the process of acquiring an aircraft that would be able to fly between the East and West coasts without refueling—something his current aircraft could do only if it had a favorable tailwind.

The nature of his business was that some years were more successful than others, and 2003 was a very successful year. For that reason, Mr. Brown wanted to insure the aircraft was treated as placed in service in 2003 so that he could take the 50% bonus depreciation available under IRC §168(k) on his aircraft—a $22 million craft that would give rise to an $11 million bonus depreciation deduction.

Of course, buying such an aircraft isn't quite the same as picking up a new Focus at your local Ford dealer in late December—the planes are generally customized and Mr. Brown's initial attempts to find a plane on his own failed. Eventually he contacted a gentleman with connections in the industry who found an appropriate aircraft that could be delivered by December 31—a condition Mr. Brown imposed on the purchase.

The jet in question had been purchased by a company on speculation, and their set of modifications would be complete by December 31. However when Mr. Brown flew to the site where the jet was now located, on the premises of a firm that performs modifications on such jets, he saw another plane the company was working on that had a conference table where his jet had two barcaloungers.

Mr. Brown decided his plane needed the conference table. The adviser who had helped him find the plane counseled against making such a modification, noting that the problem was not just its size and weight, but it required significant work modifying the jet, including installing a separate sub-hydraulic system and rebuilding the floor. But Mr. Brown determined such a table was a necessity for his business. He also decided that since he used PowerPoint as an important part of his presentations, the standard 17" video screens needed to be replaced with 20" models (if that no longer seems so large, remember this was in 2003).

This posed a problem, however, because the work needed could not be completed by December 31, the date Mr. Brown needed to have the jet in service in order to get his bonus depreciation for 2003. So Mr. Brown broke the contract into two parts—first, he would take delivery of the plane to his location in Portland, Oregon by the end of 2003.

Next he signed an agreement to have modifications made to the plane. To make these modifications he would return the aircraft to the firm that had made the initial modifications, and they would then add the conference table and upgrade the video screens.

Due to various factors, the plane's expected December 23 delivery to Portland slipped—so that it actually arrived in Portland on December 29 and delivery was accepted on December 30. Mr. Brown was aware that accepting delivery was not enough on its own—the plane had to be placed in service.

So after fueling the plane around noon, Mr. Brown was airborne, first to Seattle along with his aviation attorney (who lived in Seattle). At that location he claimed he had lunch with a client and two potential clients. After the lunch, he flew on to Chicago where he had a dinner meeting with a protégé of his. At this meeting the parties discussed business. After this meeting he returned to his vacation with his family that had been interrupted to take delivery and, in the terms used by the IRS in this case, to take "tax flights."

To support his position that these had been business flights he produced letters signed by each of the parties that stipulated the claimed meetings had taken place. However, the Court determined these letters had actually been written for the other individuals by Mr. Brown's CFO who drafted such letters when needed for IRS purposes. The letters, which the court reproduced in its opinion, certainly read like documents that someone had been asked to sign rather than original creations of the purported authors.

The Court found, as well, that in the first case the letter's corroboration of a 90 minute lunch was contracted by aircraft records that show the plane was only on the ground in Seattle for 66 minutes. Thus the Court found the letter did not add support to Mr. Brown's contention this was a business trip, but rather brought his own credibility into question—a fact not helped when Mr. Brown did not have this person or the mystery "potential clients" testify at trial.

However the Court did find the testimony of the protégé to be honest and supportive of a business discussion. Unlike his letter, the protégé's testimony was that he could not recall the details of the meeting, but he and Mr. Brown met often and each time they did they discussed various business matters. He also admitted he had not written the letters at the time of the meeting and was asked to sign letters drafted by Mr. Brown's CFO. While he thought he signed them in 2004, he indicated it was possible they weren't given to him until 2006 (when the IRS began questioning these "tax trips"). Thus, the Tax Court concluded, based on this testimony, that there had been an actual and significant business discussion.

However, the Court found the plane was not placed in service in 2003. Even if the Court were to concede there was greater than 50% business use (something not clear given the fact that the Seattle trip didn't appear to occur like Mr. Brown claimed), the aircraft could not be put into service until it was in a condition ready for the function for which Mr. Brown had purchased it.

Mr. Brown argued that he had actually used the plane for business in 2003 and that the plane was perfectly serviceable for such a use as delivered—after all, it had been configured to be a private jet aircraft with all the amenities. The Court agreed the asset Mr. Brown had on December 30 was a very nice and usable private jet—but not a jet configured to the specific functions for which Mr. Brown had purchased it.

The January 2004 modifications were, in Mr. Brown's own words, changes that were truly necessary for the plane to be useful in his business. Thus the Court found that Mr. Brown's situation was similar to that in a number of other cases where taxpayers may have gotten some use out of an asset before year end, but where the asset was truly in a state to be used as the taxpayer planned to use it by that time. In those cases, the Court consistently held the placed in service date to the date at which the equipment was finally fully ready to function as the taxpayer had intended it to function when he/she had purchased it.

Section: 170
Guidance Provided on Employer-Sponsored Leave-Based Donation Programs for Ebola Relief

Citation: Notice 2014-68, 10/29/14

Guidance has been provided on employer sponsored leave-based donation programs to aid victims of the Ebola Virus Disease (EVD) outbreak in West Africa in Notice 2014-68.

Some employers have established programs where employees are allowed to forego a portion of their accumulated vacation, leave or personal leave in exchange for the employer donating the cash value of the leave to a qualified §170(c) charitable organization. Normally such an assignment of income situation would result in an employee recognizing the income (and the employer paying the resultant payroll taxes) and the employee then being able to claim a charitable contribution on their individual return.

That treatment has a number of negative tax consequences in many cases. First, the employer is hit with the payroll taxes on the amount that was paid over to the organization. Second, the employee picks up income which raises the employee's adjusted gross income, potentially causing the employee to lose some tax benefits that are reduced or eliminated based on adjusted gross income. Third, in order to claim a benefit from the donation, the employee must itemize deductions (something a majority of taxpayers do not do). Finally, with the return of the Pease limitation, up to 80% of the donation might be lost if the employee has a high enough amount of adjusted gross income.

The notice provides relief from those consequences. The IRS will not treat such a designation as wages or income to the employee if the following conditions are met:

- Payments are made to the § 170(c) organizations for the relief of victims of the EVD outbreak in Guinea, Liberia, and Sierra Leone; and

- The payments are paid to the § 170(c) organizations before January 1, 2016.

While employees will not pick the amount up as income in this case, they will not be allowed to claim these amounts as charitable donations under §170.

The IRS also provides that they will not force the employer to treat these payments as deductible under §170 (as a charitable contribution, subject to the charitable contribution limitations), but rather allow the payments as a deduction under §162.

A similar program was previously established for programs to aid hurricane victims in Notice 2012-69 (Hurricane Sandy) and Notice 2005-68 (Hurricane Katrina).

Section: 170
Payment Made to Charity to Comply with Requirements to Retain State Operating Certificate Found to Be Business Expenses, Not Charitable Contributions

Citation: PLR 201437004, 9/12/14

Normally charitable contributions are a heavily restricted deduction for a C corporation. Unlike individuals, a C corporation can only claim charitable deductions to the extent they do not exceed 10% of the corporation's taxable income (IRC §170(b)(2)). In PLR 201437004 a taxpayer was looking for a ruling that an arrangement being entered by a partnership with a taxable corporate partner would not create a charitable contribution but rather would lead to a trade or business deduction under IRC §162.

The partnership in question consisted of a corporation and a §501(c)(3) not for profit organization corporation operating three facilities. A condition of operating the facilities involved receiving a Certificate from the State in which they were operating.

A condition of receiving the Certificate is that the value of satisfying two conditions must be at least a certain percentage of gross revenue. If the partnership fails to achieve that percentage, it must make a cash contribution to a §501(c)(3) entity of an amount equal to the shortfall.

The fact it was being paid to a §501(c)(3) organization lead to the concern that the payment could be viewed as a charitable contribution under §170, a result that presumably the corporate partner would find troublesome.

The IRS ruled the payments were not contributions because the payments were neither voluntary nor gratuitous. Rather they were found to be payments directly related to the taxpayer's business operations and therefore deductible under IRC §162.

Section: 170
Taxpayer Allowed Deductions For Charitable Contributions Made Via Corporate Advances Account, But Only When True Repayment of Advances Shown

Citation: Zavadil v. Commissioner, TC Memo 2013-222, 9/19/13

Whether a taxpayer or an S corporation the taxpayer used to own, but which was now owned by an ESOP, actually made charitable contributions was one of the matters at issue in the case of Zavadil v. Commissioner, TC Memo 2013-222, http://www.ustaxcourt.gov/InOpHistoric/ZavadilMemo.Marvel.TCM.WPD.pdf. The taxpayer remained as the corporation's CEO and on its board of directors following his sale of the stock to the ESOP.

Various charitable contributions were paid by the corporation at Mr. Zavadil's direction and then charged against his open advances account. Mr. Zavadil officially paid off the advances account each month, but often he did so by getting an advance from the corporation in the amount he owed for the previous month and then paying that balance back to the corporation.

Mr. Zavadil claimed the amounts paid to the charities as deductions on his personal returns.

The IRS objected to Mr. Zavadil's claiming the deductions. First, they argued that the corporation was not acting as Mr. Zavadil's agent in the same way as corporations had in the cases of Skripak v. Commissioner, 84 T.C. 318, and Weitz v. Commissioner, TC Memo 1989-99 since in those cases the corporation had contributed assets advanced by the taxpayers. The Tax Court did not accept this view in full, noting that the mere fact the corporation advanced the funds was not a problem so long as either Mr. Zavadil actually repaid the corporation or there was a valid debt owed by Mr. Zavadil to the corporation.

The IRS also objected, noting that the use of "circular funding" where Mr. Zavadil repaid his advances by taking an advance meant the actual economic risk was borne by the corporation. The Tax Court agreed in concept here, but did note that Mr. Zavadil had not always taken funds out to repay the balance due—until June of 2005 Mr. Zavadil had, from time to time, brought the balance owed to the corporation to zero. The Tax Court allowed Mr. Zavadil the contributions through that date.

However the Court noted that Mr. Zavadil had circular transactions for each month following that date. The Court concluded that due to the circular nature of the cash flow, the actual economic risk of making the contribution was borne by the corporation. The Tax Court also held that Mr. Zavadil failed to show there was a bona fide debt due from him to the corporation, so the Court denied all deductions from that point forward.

Clients are at times less than careful in separating personal from business payments, and quite often end up with "ledger accounts" like that for Mr. Zavadil. This case makes clear that this may produce real problems if the clients makes payments out of that account for which the taxpayer wishes to claim a deduction on his/her own personal return.

While this would normally not have been a problem if Mr. Zavadil had remained a 100% owner of the corporation, that was no longer the case. As well, if the entity had been a C corporation even being a 100% shareholder would not have helped the owner who had a similar problem.

As well, advisers must be aware that while repaying such advances is very helpful in showing bona fide debts, it is not really helpful if such repayments are accomplished solely by having the entity advance the taxpayer the funds to repay the debt. That is, an exchange of checks that produces no real change in the situation is likely to be ignored by the courts and the IRS.

Section: 172
Fact that IRS Failed to Examine Prior Years Did Not IRS Could Not Require Proof to Support Validity of Net Operating Loss Arising From Those Years

Citation: Boring v. Commissioner, TC Summary 2014-105, 11/10/14

In the case of *Boring v. Commissioner*, TC Summary Opinion 2014-105, a taxpayer discovered that merely producing tax returns from prior years is not sufficient to sustain a claim of deduction for a net operating loss.

The Borings claimed a deduction for $88,787 as a net operating loss carryforward to his 2007 income tax return. When the IRS questioned this deduction the taxpayer produced copies of their 1990-2006 income tax returns that generated the net operating loss.

The taxpayers noted that the IRS had not examined those prior years. Therefore, the taxpayers concluded, the Tax Court should accept those returns since, as the taxpayers viewed it, the IRS had accepted those returns.

The Tax Court did not agree. The mere fact the IRS had not examined those prior returns did not mean the taxpayers no longer had the burden of supporting the net operating loss being reported on their 2007 return, a return that was under examination. The Court first noted "A taxpayer claiming an NOL deduction bears the burden of substantiating the NOL by establishing both the existence of the NOL and the amount of any NOL that may be carried over to the subject years."

The Court goes on to find:

> Other than copies of prior year returns, petitioners did not produce any documentary evidence or testimony that substantiated their prior years' losses. Although petitioners' prior year returns are in evidence, without substantiation they are not credible evidence with respect to the factual issues concerning the losses so as to shift the burden to respondent. The prior year returns cannot be accepted at face without further evidence that the losses set forth were incurred. See Roberts v. Commissioner, 62 T.C. 834, 837 (1974). Petitioners' argument that the fact that respondent did not question the claimed losses, other than for the 1995 and 1996 years, means that the Court should accept them as correct is without support in the law, and petitioners did not cite any precedent that would support a holding otherwise. Accordingly we hold that petitioners have not shown that respondent erred in disallowing their claimed $88,787 NOL carryover deduction for the 2007 tax year.

Section: 172
WBHAA Did Not Impose New Temporary Ordering Rules for Alternative Tax Net Operating Losses

Citation: Field Attorney Advice 20144201F, 10/17/14

The IRS addresses an idea floated by some commentators about a "revised ordering rule" for alternative tax net operating losses created by 2008 or 2009 net operating losses (the special 3-5 loss years created by the Work, Homeownership, and Business Assistance Act of 2009 (WHBAA)). In Field Attorney Advice 20144201F the IRS concludes that, in fact, no special ordering rule exists.

Losses from those two years could offset all alternative minimum taxable income of year to which they were carried, while losses from other years are limited to 90% of AMTI. In enacting the law to provide for this special rule, Congress inserted §56(d)(1)(A) which provides the amount of an alternative minimum tax net operating loss (ATNOLD) shall not exceed:

(i) The lesser of:

(I) The portion of the ATNOLD that is attributable to ATNOLs other than WHBAA year ATNOLs; or

(II) 90% of AMTI (determined without regard to the ATNOLD or the § 199 deduction); plus

(ii) The lesser of:

(I) The portion of the ATNOLD that is attributable to WHBAA year ATNOLs; or

(II) AMTI (without regard to the ATNOLD or the § 199 deduction) minus (i) above.

Some articles have appeared where it was argued that the changes made by WBHAA to the absorption rules for WHBAA had them "held back." This theory advanced that the above change meant the taxpayer first computed the reduction in AMTI using losses carried from all years except 2008 and 2009, including losses incurred after 2009.

Only after using those losses would any WHBAA losses be used. So, for instance, if a taxpayer had $100,000 of AMTI in 2011 and had available ATNOLs of $200,000 from 2010 and $100,000 from 2009, the taxpayer would first offset $90,000 of AMTI from the 2010 losses, and then take the final $10,000 from the 2009 unused losses.

This would leave the taxpayer with $90,000 of 2009 NOLs that could be used to "pick up" the final 10% of AMTI for 2012 and $110,000 of 2011 NOL that could serve to offset the first 90% of AMTI for 2012.

The Field Advice argues this view is in error. The FAA holds that the computation in §56(d)(1)(A) only provides the amount of loss to be used, but not which losses are used. In the view of the FAA the above taxpayer would have its 2009 ATNOL entirely absorbed and only $200,000 of 2010 (limited to 90% of AMTI) net operating loss to carryforward.

Obviously this is solely the opinion of the Chief Counsel's office and a court might rule differently—but, clearly, the memo indicates that the IRS is unlikely to accept such a treatment when examining a the loss deduction for a year. So advisers who have clients that wish to take such a position should advise the client of the fact that the IRS is very likely to take a contrary position, and that recourse to court (not an inexpensive process) might be necessary to be able to carry the alternative view.

Section: 172
Loss on Stock of Subsidiary Rendered Worthless Due a Product Liabiilty Issue at Subsidiary Level is Not a Specified Product Liability Loss

Citation: Chief Counsel Memorandum 201442054, 10/17/14

One of the special net operating carryback provisions that allows for carrying back a loss for a longer period than the standard two years relates to specified product liability losses as defined by IRC §172(f)(1)(A)(i). Losses related to such items qualify for a ten-year carryback pursuant to IRC §172(b)(1)(C).

In Chief Counsel Memorandum 201442054 the question arose as to whether a taxpayer incurred such a loss when it recognized a loss on the disposition of stock of a subsidiary that was driven into bankruptcy by a product liability problem. The specific facts of the bankruptcy were as follows:

> Pursuant to the (bankruptcy reorganization) Plan, the existing stock of Sub1 held by Taxpayer was cancelled and new common stock of reorganized Sub1 was issued, but Taxpayer did not receive any shares of the new common stock. Further, Sub1 established a qualified settlement fund (QSF) within the meaning of § 1.468B-1 of the Income Tax Regulations, and transferred to the QSF cash and property, including its new common stock, promissory notes, rights under certain insurance policies, and other assets. In exchange, Sub1 was relieved of all present and future claims related to ProductD and the QSF assumed responsibility for such claims.
>
> On its Year3 consolidated tax return, the consolidated group claimed a deduction under §§ 162 and 468B for Sub1's contribution of its new common stock to the QSF. The group also claimed a deduction under § 165(g) for Taxpayer's worthlessness of its Sub1 stock.

The memorandum looked at the definition of a specified product liability loss under IRC §172(f)(1)(A). That section defines such a loss as amounts allowed as a deduction under either IRC §162 (the ordinary and necessary business loss rule) or §165 (the more general loss rule) which is attributable to:

- Product liability (defined by §172(f)(4) as "*liability of the taxpayer* for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product."), or
- Expenses incurred in the investigation or settlement of, or opposition to, *claims against the taxpayer* on account of product liability.

The memorandum specifically highlighted the "liability of the taxpayer" and "claims against the taxpayer" clauses when reciting these rules. The memorandum notes that the taxpayer (the parent corporation) did not manufacturer, lease or sell the product in question nor was there was a claim directed against the parent.

Rather the taxpayer had a loss that arose from the worthlessness of its investment in the stock of the subsidiary. As such, the loss failed to qualify as a specified product liability loss and the taxpayer was not eligible for the extended ten-year net operating loss carryback period on the loss incurred.

Section: 172
NOL Arising From "Closed" Year Must Still Be Supported By Records to Allow Deduction in Later Year

Citation: Obedin v. Commissioner, TC Memo 2013-223, 9/23/13

All items affecting the computation of tax for a year are open to question during an examination and the taxpayer must produce support for claimed amounts even if that support is from a "closed" year. In Obedin v. Commissioner, TC Memo 2013-223, (http://www.ustaxcourt.gov/InOpHistoric/ObedinMemo.Cohen.TCM.WPD.pdf), a taxpayer was denied a substantial portion of a net operating loss carryover due to a failure to produce such evidence.

In the case in question the taxpayer claimed a net operating loss carryover of $208,195 on their 2004 tax return but did not attach any schedule describing or computing the NOL carryover claimed.

Their 2004 return was examined by the IRS, something that was not new to the taxpayers as their 2003 return had been examined by the IRS. The agent asked for supporting documents to back up the claimed NOL, including all records relating to 2003. The taxpayers responded to this request by solely providing copies of their 1997-2003 income tax returns, the returns from which they claimed the NOL carryover flowed.

The agent discovered certain expenses had been deducted twice by the taxpayer on their 2004 return. The agent, facing the fact that the taxpayers were providing no detailed records for 2003, took the position that it was likely the same errors had taken place in prior years and thus reduced the NOL carryover by over ½.

The taxpayers cried foul. For the court they produced an analysis attacking the agent's computation of the NOL but provided no information regarding the years the carryover arose from. As well, the taxpayers could not explain why the double deductions had taken place in 2004, nor document that the same error had no taken place for the prior year.

Based on that record, the Tax Court found that only the amount of NOL that the IRS agent had allowed was properly deductible in 2004. The Court implies (and this author would agree) that the agent had actually been rather generous allowing any net operating loss in this case where there was no support provided by the taxpayers.

This wasn't the taxpayer's only problem—they also faced a reduction in basis on the sale of an asset. In this case the Tax Court seemed to believe it was very possible the basis should include the items the taxpayers suggested it should, but again the lack of sufficient records caused the Court to conclude that there wasn't enough support to overcome the presumption that the IRS's position was the correct one.

The case is a good example of two separate issues. First, taxpayers and advisers should not think of years as "closed" (and thus no longer relevant) so long as there are carryovers flowing from the year onto returns that are still open for tax assessment. The statute of limitations solely applies to whether the IRS can assess and collect tax against a particular year—but in this case the IRS was not assessing tax for 2003, but rather assessing against 2004. Since excessive deductions in 2003 would have flowed into the net operating loss and affected the 2004 return, all the records of 2003 were necessary to defend the 2004 return from IRS attack.

Similarly, taxpayers need to be sure to keep records that clearly indicate and support basis for assets that are later sold. In this case the problem was that the taxpayers had other transactions taking place at the same time, and it wasn't totally clear that these payments related to the specific project the taxpayers had or that they weren't included in other documents provided to support a basis calculation.

Section: 179
Guidance Released on Qualified Real Property §179 Provisions

Citation: Notice 2013-59, 9/10/13

In Notice 2013-59 (http://www.irs.gov/pub/irs-drop/n-13-59.pdf) the IRS clarified the application of the expanded §179 expensing options for certain real property following its extension by the American Taxpayer Relief Act of 2012 (ATRA).

A taxpayer that elects under §179(f) to include "qualified real property" in its §179 expensing for tax years beginning in 2010-2013 is able to expense up to $250,000 of such items each year.

Generally, "qualified real property" for these purposes needs to fit into one of three categories:

- Qualified leasehold improvement property
- Qualified restaurant property
- Qualified retail improvement property

The law provides that such amounts, if disallowed under the taxable income limitations on §179 expensing for a year, may not be carried forward to a year following the last year for which these rules apply.

Prior to amendment by the ATRA, the provision only applied to assets placed in service in tax years beginning in 2010 and 2011. If a taxpayer had a carryover amount that was unused at the end of 2011, the unused amount was treated under the standard depreciation rules as if it had been placed in service:

- On the first day of the last tax year beginning in 2011 for 2010 tax year carryovers *and*
- On the last day of that same year for unused 2011 amounts

As Congress did not extend this provision until early 2013 retroactive into 2012, taxpayers preparing 2011 returns that ended up with "unused" real property §179 on their 2011 returns prepared their returns assuming that the amounts had to be treated under those rules noted above.

Now, of course, the rule has been retroactively changed so that the year of reckoning does not occur until 2013. In this notice, the IRS provides that a taxpayer in this predicament may, but is not required to, change its 2011 return to reflect a carryover of the unused amount into 2012 and remove those assets from the computation of depreciation in 2011. The taxpayer is allowed to make this revision at any time during which the statute of limitations remains open for all years affected by a status change.

The notice also clarifies that, any disallowed §179 deduction for any year is presumed to first consist of the ratio to qualified real property subject to the §179 election to other property subject to the §179 election.

If a taxpayer disposes of such qualified real property during 2010, 2011, 2012 or 2013 in a transaction in which gain or loss is not recognized in whole or in part (including transfers at death), the basis of the property is increased by any outstanding carryover of disallowed loss attributable to that property immediately before the disposition. However, this rule will not apply to any such disposition in the taxpayer's LAST taxable year beginning in 2013 or any subsequent year.

Any amounts expensed related to qualified real property is treated as §1245 and not §1250 property. Any remaining adjusted basis is treated as §1250 property. Any reasonable method may be used to allocate between §1250 gain and §1245 gain. The IRS specifically gives examples of using either a pro-rata allocation of the sales price between the §1245 and §1250 portions of the property or allocating the gain first to the §1245 recapture and then treating the remainder as §1250 gain.

Thus, a taxpayer has a trade-off that must be recognized in electing this treatment. Upon the eventual sale of the property, there will be an ordinary income recapture component. That will be true even if the taxpayer holds the property until such time as the item would have been fully depreciated without the §179 election.

Section: 181
No Authority Exists to Allow Late §181 Election

Citation: Staples v. Commissioner, TC Memo 2013-262, 11/18/13

Trying to salvage a deduction that otherwise would not be allowable, an attorney who was undertaking a film project attempted to argue on exam that he should be allowed to make a late §181 election. The Court ruled in the case of Staples v. Commissioner, TC Memo 2013-262, http://www.ustaxcourt.gov/InOpHistoric/StaplesMemo.Wherry.TCM.WPD.pdf, that such an option wasn't open to the taxpayer.

Mr. Staples began research into a film-making project in 2007. On his return for that year, which he prepared himself, he deducted expenses related to research for his film series. He did not attach an election under IRC §181 to the return.

Generally research expenses of this sort are not deductible, captured by IRC §263A and capitalized. However, for qualifying film and television productions, expensing is allowed if there is a timely election made under §181 to expense the items. The election must be made in the form the IRS provides and by the due date (including extensions) for filing the return [IRC §181(c)].

The taxpayer admitted he didn't attach such an election, but argued the Court should allow him to make one now that the IRS was disallowing his deductions.

The Court found that merely listing the expenses on his Schedule was not effective as an election under §181. The Court noted:

> Petitioner did not allege that a timely section 181 election was made for the 2007 taxable year but asks "the Court to treat Petitioner as if an election to apply section 181 was timely made." The Court cannot and will not do so as it has no authority to rewrite the statute or the regulation. Petitioner does not meet the statutory requirement for a qualifying section 181 election and therefore may not deduct his film research and location exploration expenses for 2007.

The Court also noted that even if it had decided he had substantially complied with the requirement, since he had not begun principal photography even as of the date of the trial, the activity would have failed to meet the basic requirements for a qualifying film and television production.

Section: 195
Rental Properties Not Truly Available to Rent in 2008, Expenses Must be Capitalized as Start-Up Expenses

Citation: Gordon v. Commissioner and Jarrett v. Commissioner, TC Summary Opinion 2013-91, 11/18/13

Taxpayers who purchase rental properties often believe they should be able to deduct expenses immediately upon purchasing the property, even if it is not ready to be rented at that time. As the taxpayers in the related cases of Gordon v. Commissioner and Jarrett v. Commissioner, TC Summary Opinion 2013-91, http://www.ustaxcourt.gov/InOpHistoric/JordanSummaryBuch.SUM.WPD.pdf, discovered, IRC §195 related to start up expense applies to rental activities just as it does to traditional business activities.

The taxpayers had purchased a home in 2008. They deducted various expenses paid in 2008 on their return. The house was not actually rented in 2008, not being occupied by a tenant until 2009. There was one application to rent the house in 2008, which was completed before they acquired the home. A number of months after they acquired the home, they reviewed the application and rejected the proposed tenant.

The owners performed a number of repairs on the property in 2008. In 2009 they obtained another application to rent. This applicant was eligible for housing assistance, requiring an inspector from HUD to approve the home. The inspected required additional repairs to be made to the home before approving it, repairs they made.

The Tax Court found that the taxpayers did not actually start their rental formally until 2009 when the property was actually available for rent and they were actively searching for tenants. The Court found that aside from the application that existed before they actually owned the property, there was no activity that indicated an intent to rent in 2008.

Rather the parties seemed primarily involved with repairing the properties to prepare them for later rent. The Court found no reason to accept their assertion that they had been seeking tenants via word of mouth in

2008 to be sufficient to show the properties were truly being offered for rent. The taxpayers did not help their case, either, by listing a 2009 placed in service date on their 2009 returns.

Rather, all expenses incurred in 2008 were required to be treated as start-up expenditures, capitalized under §195 for later recovery as deductions.

Section: 199
Bank Did Not Generate DPGR from Free App Download That Gave Access to Services That Generated Fees

Citation: Generic Legal Advice Memorandum AM 2014-008, 12/5/14

The deduction under §199 for domestic production continues to lead to questions about "edge case" situations, and Generic Legal Advice Memorandum AM 2014-008 looked at the question of whether a bank that allows customers to download a free app may nevertheless be deemed to have derived domestic production gross receipts (DPGR) from the disposition of software when the app allows the customers access to services for which bank derives fees.

As the ruling describes the set-up:

> Although A does not charge its customers a fee to download or access its App, customers may incur fees for receiving some banking services provided via A's App that are equal to the fees A's customers incur for receiving banking services via A's website. These fees may vary from the fees A charges to provide banking services at A's banking facility. For example, A charges customers $25 per wire transfer and $1 per check deposit initiated via its App or its website, and $40 per wire transfer and no charge per check deposit initiated at its banking facility. Alternatively, A may charge a $5 monthly banking fee for banking services and not distinguish between services provided to customers through its branches, websites, or App. For financial purposes, A recognizes these revenues as from the provision of banking services.

While, generally, Reg. §1.199-3(i)(6)(ii) provides generally that receipts from items such as customer and technical support, telephone and other telecommunication services, and online services are not DPGR, they may be DPGR if the revenue meets one of two exceptions at Reg. §1.199-3(i)(6)(iii).

The memo describes these two exemptions as follows:

> The first exception (the self--comparable exception), in § 1.199-3(i)(6)(iii)(A), applies to a taxpayer that derives, on a regular and ongoing basis in the taxpayer's business, gross receipts from the disposition to customers that are unrelated persons of computer software that (1) has only minor or immaterial differences from the online software; (2) was MPGE by the taxpayer in whole or in significant part within the United States; and (3) has been provided to such customers affixed to a tangible medium or by allowing them to download the computer software from the Internet.
>
> The second exception (the third--party comparable exception), in § 1.199-3(i)(6)(iii)(B), applies if another person derives, on a regular and ongoing basis in its business, gross receipts from the disposition of substantially identical software (as compared to taxpayer's online software) to its customers pursuant to an activity described in § 1.199-3(i)(6)(iii)(A)(3) (i.e., by a tangible medium or download from the Internet). Section 1.199-3(i)(6)(iv)(A) defines substantially identical software as computer software that (1) from a customer's perspective, has the same functional result as the online software; and (2) has a significant overlap of features or purpose with the online software.

The ruling holds that the transaction in question is not disposition of computer software when customers download the app.

The memo notes:

> Pursuant to the general rules of §§ 1.199-3(i)(6)(i) and (ii), offering customers access to online software is not a qualifying disposition of computer software. Section 1.199-3(i)(6)(ii), as well as Examples 1, 2, and 3 in § 1.199-3(i)(6)(v), describe service activities that are conducted online, which do not involve a disposition of computer software. Included in that list are online banking services, of which A is a provider. The clearest example of A providing online banking services is when customers use A's website to access A's computer software (internal banking software) to order banking services. The gross receipts derived when customers use A 's website are non- DPGR because A is providing banking services via the website and is not disposing of computer software.

The memorandum holds that the app in question effectively duplicates the online website and offers no functionality beyond that site. Therefore, the downloading of the app is not a "disposition of computer software" for purposes of §199.

The memo goes on to explain:

> While the § 199 regulations contain references to computer software downloads as dispositions, the intent is to include downloaded software that has independent functionality after customers have downloaded it and are no longer connected to the Internet. See, e.g., Treas. Reg. §§ 1.199- 3(i)(6)(iii) and (v), Example 4. This makes sense because if customers can only use downloaded computer software while connected to the Internet, the software cannot be materially distinguished from other software that customers access and directly use while connected to the Internet that is not downloaded (i.e., it is equivalent to online software).

It then goes on to contrast this with a case that is considered a disposition—tax preparation software offered by a vendor both on a CD and online. The memo continues:

> Section 1.199-3(i)(6)(v), Example 4, related to the self--comparable exception, is illustrative of a computer software download that results in a qualifying disposition of computer software. In Example 4, a taxpayer, O, produces tax--preparation computer software that it provides to customers on either a compact disc, by allowing them to download it, or by allowing them to access it while they are connected to the Internet. The regulations treat the downloaded software as a qualifying disposition that O can use as a self--comparable under § 1.199-3(i)(6)(iii)(A) to qualify gross receipts from its online software. However, O's tax preparation software is distinguishable from A's App because the tax preparation software will function and O's customers can use it to perform the desired service (preparing a tax return) even if O's customers are not connected to the Internet. A 's App does not function in a similar manner to the downloaded tax- preparation software, but instead functions like a website, and thus, A is not treated as disposing of computer software merely because customers download its App.

The memo also concludes that even if the download were to be held to be a disposition, the bank derives no gross receipts from the download. The memo notes:

> In this case, A does not charge its customers a fee to download its App. Instead, A charges fees only for completed banking transactions, e.g., check deposits or wire transfers (or A may charge a flat monthly fee for all banking services). A 's App serves as an alternative means for A to connect with its customers (just like A's website, mobile website, and the tellers employed at A's bank) and solely functions to enable A's customers to receive A's banking services. A's internal banking software and

systems perform the service, but are not disposed of by A. Examples 1, 2, and 3 of § 1.199-3(i)(6)(v) show that computer software produced to enable customers to receive and/or participate in online services is part of the online service, and gross receipts are not separately allocable to such computer software. A, therefore, derives gross receipts from the provision of banking services and not from allowing its customers to download its App.

Section: 199
Software Developer Had DPGR Income Despite Income Being Bsaed on Services Provided to Third Parties by Contracting Parties

Citation: TAM 201445010, 11/7/14

In TAM 201445010 the IRS ruled that a corporation's income from licensing of software to a third party that provided services to other parties constituted Domestic Production Gross Receipts (DPGR) for purposes of the IRC §199 deduction from domestic production. This was true despite the fact that the corporation received its income from a payment made by the licensing entity each that entity used the software to provide a service to a end user.

As the IRS describes the agreements:

> Under master agreements with each of the Contracting Parties, Taxpayer designs and develops unique Computer Software for each Contracting Party's data, and Taxpayer licenses the Computer Software to the Contracting Parties. An End User subscribes to a product or service by entering into a subscriber agreement with both Taxpayer and the respective Contracting Party. Under the subscriber agreement, the End User submits a service request to the Contracting Party, and the Contracting Party uses the licensed computer software and the Contracting Party's data to perform the service (generation and distribution of the Results) with the Results provided by the Contracting Party to the End User. In some cases, Taxpayer grants the End User a license to use the Results. Under the subscriber agreement, the Contracting Party collects End User fees. The Contracting Party pays Taxpayer an amount as provided under the respective master agreement.

The examining agent believe that this arrangement resulted in the entity being paid for a service rather than for the licensing of software, a transfer that would not generate DPGR. The taxpayer argued, rather, that since the entity it licensed the software to was performing the service, the income represented fees for the development of software that were part of DPGR.

The examining agents believed the case was similar to the following examples, whose description in the TAM are reproduced below that are found in the regulations:

> Section 1.199-3(i)(6)(v), Example 1, provides that L is a bank and produces computer software within the United States that enables its customers to receive online banking services for a fee. Under §1.199-3(i)(6)(ii), gross receipts derived from online banking services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, L's gross receipts derived from the online banking services are non-DPGR.
>
> Section 1.199-3(i)(6)(v), Example 2, provides that M is an Internet auction company that produces computer software within the United States that enables its customers to participate in Internet auctions for a fee. Under §1.199-3(i)(6)(ii), gross receipts derived from online auction services are attributable to a service and don ot constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. M's activities constitute the provision of

online services. Therefore, M's gross receipts derived from the Internet auction services are non-DPGR.

> Section 1.199-3(i)(6)(v), Example 3, provides that N provides telephone services, voicemail services, and e-mail services. N produces computer software within the United States that runs all of these services. Under §1.199-3(i)(6)(ii), gross receipts derived from telephone and related telecommunication services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, N's gross receipts derived from the telephone and other telecommunication services are non-DPGR

The National Office agreed with the taxpayer. The TAM notes:

> Our view of the facts supports the conclusion Taxpayer derived gross receipts from the license of Computer Software to the Contracting Parties, and not from providing services to End Users. In our view, the substance of Taxpayer's relationship with the Contracting Parties is that Taxpayer produces the Computer Software used by the Contracting Parties to provide services to End Users. However, even though LB&I and Taxpayer agree on the facts described above, the parties reach a different conclusion as to which party is paying Taxpayer.

The memorandum goes on to distinguish this case from the examples by noting:

> LB&I compared Taxpayer's situation with those of the taxpayers described in Examples1, 2, and 3 in § 1.199-3(i)(6)(v). These examples illustrate the rule in §1.199-3(i)(6)(ii) and describe situations where a taxpayer producing computer software does not lease, rent, license, sell, exchange, or otherwise dispose of such computer software, but instead uses the computer software to provide online services to customers. The gross receipts are determined to be non-DPGR because the taxpayers are deriving gross receipts from providing services, not from the license of computer software. Taxpayer's facts are different from these examples. Here, Taxpayer licenses (disposes of) the Computer Software to the Contracting Parties, and the Contracting Parties (not Taxpayer) use the Computer Software to provide services to End Users. Thus, the examples do not support the conclusion that Taxpayer's gross receipts are derived from services.

Section: 199
Taxpayer Denied §199 Deduction for Subcontracted Manufacturing, Found Not to Be "The" Owner

Citation: ADVO, Inc v. Commissioner, 141 TC No. 9, 10/24/13

In 2005, the Congress of the U.S. directed the IRS to issue regulations insuring that in a situation where one party contracts with another (effectively "outsourcing") entity to actually manufacture tangible personal property, that only 1 of the two entities may claim the §199 deduction [Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, Sec. 403(a)(13)]. The IRS issued regulations holding that a "benefits and burdens of ownership" test is to be used in such a case. [Reg. §1.199-3(e)(1)]

In the case of ADVO, Inc v. Commissioner, 141 TC No. 9, http://www.ustaxcourt.gov/InOpHistoric/AdvoDiv.Wherry.TC.WPD.pdf, the Tax Court found its first case under which to attempt to apply these rules. The taxpayer in this case is an entity that sold advertising direct mail packets, with a number of advertisers having their ads "bundled" in a single ADVO mailing. In some cases, ADVO itself would agree to print the ads on behalf of the client, including potentially being deeply involved in the specific design of the ad for the client.

ADVO did not itself have printing facilities. Rather, it subcontracted the necessary printing jobs to various printers around the country who ran their print jobs in the United States. The printers in question had to use paper from a source approved by ADVO and their product had to meet specific standards for the job to be accepted by ADVO.

As the Court noted, some entity would get the deduction here, be it either the printers or ADVO. The key question was who, though as the Court pointed out, it was very likely the deduction would be much greater if ADVO had it allocated than if the printers did.

ADVO argued that it had the benefits and burdens of ownership, pointing the Court to its decision in the case of Suzy's Zoo v. Commissioner, 114 TC 1. Suzy's Zoo developed cartoon characters for its line of paper products and then contracted out the actual printing of such products to third parties. In that case, Suzy's Zoo was found to be the owner of the products for §263A purposes.

However, the IRS notes that the regulations for §263A talk only about an entity being <u>an</u> owner of property, while §199's regulations speak of <u>the</u> owner. In the first case more than one entity may be an owner, but in the second case only one party can be the owner. The Tax Court agreed that while the §263A factors may be useful in dealing with a §199 case, the Court is not bound by the holding of Suzy's Zoo to find that ADVO is <u>the</u> owner of the product.

The Court goes on to note that Example 1 of Reg. §1.199-3(f)(4) provides where one party controls the intellectual property and then contracts with a second party to manufacture the product, the second party is deemed to be "the" owner if it controls the details of the manufacturing process, bear the risk of loss or damage during manufacturing, has legal title to the property during the manufacturing, and enjoys the economic gain or bears the burden of the loss based on the difference between its costs and its fixed contract price. The Court also noted the decision in the case of Grodt & McKay Realty, Inc., v. Commissioner, 77 TC 1221, provided a useful analysis of factors cited by both parties in the case, and that the factors under IRC §936 are also relevant.

Considering those sources, the Court outlined the following factors to be considered in determining "the" owner under §199 in a contract manufacturing case:

- Whether legal title passes;
- How the parties treat the transaction;
- Whether an equity interest was acquired;
- Whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments;
- Whether the right of possession is vested in the purchaser and which party has control of the property or process;
- Which party pays the property taxes;
- Which party bears the risk of loss or damage to the property;
- Which party receives the profits from the operation and sale of the property; and
- Whether the party that outsources the manufacturing actively and extensively participated in the management and operations of the activity

The Court noted this is a "facts and circumstances" cases and that thus no single factor is determinative. Rather, the overall facts and circumstances of the case must be considered.

The following were found to be factors in favor of the IRS's position that ADVO was not "the" owner for §199 purposes. The Court found that under the agreements, title did not pass to ADVO until the products left the printer's facilities. The Court found the parties intended that the printers produce the tangible material using ADVO intangible pre-press materials. The Court found that ADVO did not exercise day-to-day control over the activities of the printers. The printers bore the risk that their costs on the job would exceed the fixed price, and reaped the benefits if their costs came in lower than expected. The Court noted that while ADVO did actively participate in services (mailing and dissemination of advertising materials), it did not extensively participate in the actual manufacturing (operation of printing presses, cutting, or folding).

The following factors were deemed neutral in this case. The Court did not deem the equity interest and present obligation factors were not significant factors in the case. No evidence was provided with regard to which party was paying any property taxes on these materials. As well, while the printers had some risk for loss or damage, ADVO also had the risk if the job wasn't completed timely of losing out on the agreement with the customer, so that risk of loss or damage existed at both levels.

With a number of factors coming out in favor of the IRS's position that ADVO was not the owner and a finding of no factors in favor of ADVO's position that it was the owner, the Tax Court ruled that the printers, and not ADVO, were the owners of the property in question and thus were the parties that could claim the §199 deduction.

It is useful to note that during the case one of the taxpayer's own printers was called to the stand and had to admit that it had claimed the §199 deduction on its own return. It would not be surprising to find that all of the printers had done so, a fact that illustrates the very issue that Congress was concerned about in the 2005 command to the IRS.

Section: 263
Payments to Retailers Selling Taxpayers Products to Subsidize Construction of Displays Are Currently Deductible

Citation: CCA 201405014, 1/31/14

A taxpayer provided payments to its retailers for construction of an area to show off the taxpayer's products and the issue arose about whether the payments were required to be capitalized or could be currently expensed by the taxpayer.

The taxpayer offers its retailers financial support for constructing a facility conforming to the taxpayer's standards to market the taxpayer's products. The retailer has to repay the support if, before the expiration of 15 years, the retailer either seeks approval to change the structure so it no longer is in compliance with the taxpayer's requirements or no longer sells the taxpayer's products. However, the retailer is under no obligation to purchase any specific quantity of the taxpayer's products and the only right the taxpayer receives is the right to require the retailer to conform its premises to the taxpayer's standards.

In Chief Counsel Advice 201405014 (http://www.irs.gov/pub/irs-wd/1405014.pdf) the IRS considered the issue of whether the taxpayer must capitalize these amounts or can currently expense them. The advice concluded that the payments are, in fact, currently deductible as marketing expenses.

The ruling determined that the taxpayer received an intangible benefit of some sort. The ruling concluded that the right in question did not create or enhance a separate and distinct intangible because they have no value apart from the promotion of the taxpayer's products.

The IRS also concluded that the agreement did not create a financial interest under Reg. §1.263(a)-4(d)(2) since there was no requirement the retailers purchase any specific quantity of product from the taxpayer. For similar reasons, the advice concludes that no contract right under Reg. §1.263(a)-4(d)(6).

Finally, the ruling concludes that the specific items did not result in improvements to real property, thus dodging the provisions of Reg. §1.263(a)-4(d)(8).

The IRS concluded these were the only provisions that potentially could have required capitalization of these payments, thus the taxpayer is allowed to currently expense these payments to retailers.

Section: 263
IRS Releases Final Revised Capitalization/Repair Regulations and Updates Automatic Accounting Method Changes

Citation: TD 9636, REG 110732-13 and Revenue Procedure 2014-16, 9/19/13 and 1/24/14

The latest round of revisions to the repair and capitalization regulations have made their way out of the IRS, but this time the majority of the regulations were issued as final regulations (TD 9636, https://s3.amazonaws.com/public-inspection.federalregister.gov/2013-21756.pdf) with the regulations under IRC §168(i) reissued as proposed regulations with further revisions (REG 110732-13, https://s3.amazonaws.com/public-inspection.federalregister.gov/2013-21753.pdf).

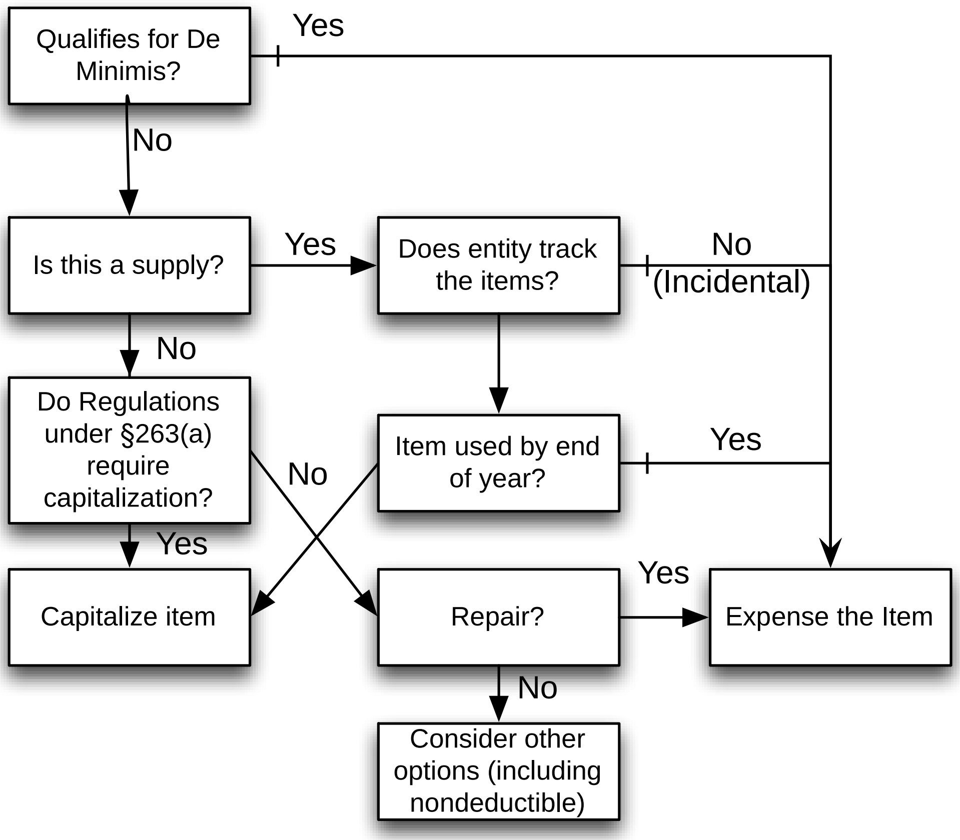
Late in 2012 the IRS had issued Notice 2012-73 which delayed the effective date of the then temporary regulations. The notice also indicated specifically that the IRS expected to make changes to simplify compliance, and the notice provides that such changes are to be expected in the following provisions:

- De Minimis Rule: § 1.263(a)-2T(g);
- Dispositions: §§ 1.168(i)-1T and 1.168(i)-8T; and
- Safe Harbor for Routine Maintenance: § 1.263(a)-3T(g)

The final regulations did introduce changes to the De Minimis Rule and the Safe Harbor for Routine Maintenance, while the proposed regulations deal with modifications to the dispositions rules.

Originally the IRS issued in late 2011 the third revision of the proposed regulations on capitalization, this time issuing at the same time identical temporary regulations, in TD 9564. These regulations would, among other things, attempt to outline rules for determining whether an expenditure was a repair that could be currently expensed, or a capitalized improvement that must be depreciated for tax purposes.

A rough flowchart of how the final regulations may be viewed is presented below:



Reg. §1.263(a)-1 outlines general rules for capital expenditures, Reg. §1.263(a)-2 provides provisions related to the acquisition of tangible property while Reg. §1.263(a)-3 deals with the improvement of tangible property. Temporary regulations were also added under IRC §§162 (related to materials and supplies, repairs and rentals), 165 (related to obsolescence of nondepreciable property), 167 (related to depreciation), 168 (related to cost recovery), 263A (related to uniform capitalization) and §1016 (related to the basis of assets).

While the temporary regulations roughly followed the 2008 proposed regulations, certain changes were made by the IRS, with additional changes made in the final regulations. Many provisions in these regulations will require a change of accounting method involving an automatic change request on a Form 3115 and a §481(a) adjustment. In the preamble to the regulations the IRS justified a §481(a) adjustment as opposed to a cut-off adjustment to insure the same standards applied to all assets and transactions in a year under examination.

MATERIALS AND SUPPLIES AND ROTABLE SPARE PARTS [Reg. §1.162-3]

The regulations clarify the nature of materials and supplies. Generally such items that are “nonincidental” must be deducted against income in the year in which they are used or consumed. If the materials and supplies are “incidental” they can be expensed in the year in which they are acquired so long as a) no record of consumption is kept by the taxpayer and b) income continues to be clearly reflected even with such immediate expensing. [Reg. §1.162-3(a)]

Reg. §1.162-3(b) notes that this regulation does not change the treatment of items under any provision of the IRC, thus if another provision requires an expense to be capitalized the fact that the above rules would allow expensing would not justify such expensing.

Materials and supplies are defined as tangible personal property other than inventory that falls into one of the following categories:

- A component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property;
- Fuel, lubricants, water, and similar items reasonably expected to be consumed within 12 months;
- A unit of property as determined under § 1.263(a)-3T(e) that has an economic useful life of 12 months or less;
- A unit of property as determined under § 1.263(a)-3T(e) that has an acquisition cost or production cost (as determined under IRC §263A) of $200 or less (or such amount as the IRS may later publish to adjust this figure in the future)

The final category of materials and supplies was modified in the final regulations, raising the level at which an item can be treated as a supply regardless of other factors from $100 to $200.

Rotable spare parts are treated differently from other materials and supplies. Such items are generally treated as expensed in the year in which the taxpayer disposes of such parts. [Reg. §1.162-3(a)(3)] Rotable spares parts are defined as materials and supplies "that are acquired for installation on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation." [Reg. §1.162-3(c)(2)] Temporary spare parts are materials and supplies "that are used temporarily until a new or repaired part can be installed and then are removed and stored for later (emergency or temporary) installation."

The regulations provide an alternative method that can be used for such parts. The taxpayer can deduct the cost of the parts when the part is first installed. However if such a part is later removed from a piece of property the taxpayer must include the fair value of the part in income at that point, deducting that amount only when the part is installed in another piece of equipment or is disposed of. The taxpayer also may not currently deduct any amounts paid to maintain, repair or improve the part, but must add them to the basis of the part. Both of the permissible methods are considered a method of accounting for income tax purposes, thus a taxpayer must ask for permission before being able to switch from one method to another.

A somewhat more generous option than the $200 cost option is available to taxpayers who meet certain criteria, and this option applies to items beyond merely materials and supplies (though the $200 rule is limited to materials and supplies).. The rule is somewhat different depending on whether a taxpayer has an "applicable financial statement" or not. In the original proposed regulations only taxpayers with applicable financial statements could use the de minimis rule.

A more generous *de minimis* rule can be applied by a taxpayer who meets all of the following criteria [Reg. §1.263(a)-1T]:

- A financial statement that is either:
  - Filed with the Securities and Exchange Commission;
  - A statement audited by an independent CPA that is used for credit purposes, reporting to equity holders or for any substantial non-tax purpose or
  - A statement other than a tax return required to be provided to an agency of the federal or a state government (other than the IRS or the SEC)

- The taxpayer had written accounting procedures in place at the beginning of the taxable year treating amounts below a certain figure as an expense for nontax purposes
- The amounts are treated as an expense on the applicable financial statement
- Items falling into this category have an invoice price of no more than $5,000

The temporary regulations previously had an aggregate limitation based the greater of a percentage of gross revenue or of financial statement depreciation. The invoice cost rule was substituted for this test to respond to complaints that the aggregate tests would have required accounting for all small items, while the whole purposes of a capitalization policy was to simplify the accounting process by eliminating such tracking.

Note that many privately held entities will not have an "applicable financial statement" under these rules and thus will not qualify for the *de minimis* method. However, the final regulations added a provision for such taxpayers, though with a significantly lowered invoice limit.

Such taxpayers must have procedures in place that insure consistent policies are followed regarding the capitalization policy and the items in question must be reflected as an expense on the taxpayer's books and records. In this case, the taxpayer without an applicable financial statement may use a de minimis method, but the method is not available for any item whose invoiced price is more than $500.

The regulations do not require any specific language for such a capitalization policy—just that it be in force prior to the beginning of the tax year and that it be followed by the taxpayer for either its applicable financial statement (if the taxpayer has one) or in keeping its books and records (for a taxpayer without an applicable financial statement).

The preamble does make clear, though, that the IRS does intend to strictly enforce the rule that the accounting policy must be in force prior to the beginning of the tax year. The preamble gives the following comments in rejecting a suggestion to allow for a retroactive adoption of such a policy:

> ...[T]he final regulations are not applicable until taxable years beginning on or after January 1, 2014. Therefore, taxpayers without written accounting procedures that choose to elect the de minimis safe harbor for their 2014 taxable years should have sufficient time to consider and draft appropriate procedures prior to the applicability date of the final regulations. Moreover, the de minimis safe harbor is intended to provide recordkeeping simplicity to taxpayers by allowing them to follow an established financial accounting policy for federal tax purposes, and allowing retroactive application is inconsistent with such purpose.

Or, to put it more simply, the IRS believes that since taxpayers had over three months notice of the need to have such a policy in place, those who wished to use this method had ample notice of the need to develop such a policy.

Technically the final regulations do not specifically require the accounting procedures to be in writing for a taxpayer without an applicable financial statement (though a taxpayer with one must have it in writing), a lack of a written set of procedures would make it very difficult to show the procedures were actually in place as of the beginning of the year. [Reg. §1.263(a)-1(f)(1)(i)(B) as compared with Reg. §1.263(a)-1(f)(1)(ii)(B)]

The *de minimis* method cannot be used for amounts in inventory nor for land. [Reg. §1.263(a)-1]

A taxpayer using the *de minimis* rule must attach an election in conformity with the provisions of Reg. §1.263(a)-1 to its income tax return for the year in question.

Advisers should note that these rules do not mean that all items costing more than the allowed *de minimis* amounts will need to be capitalized even if the item otherwise qualifies for capitalization. The preamble to the proposed regulations contain the following language that clarifies that this is a relief provision, and that prior law rules (does your policy misstate income) will continue to be used for amounts in excess of the applicable invoice amount:

> Finally, for both taxpayers with applicable financial statements and taxpayers without applicable financial statements, the de minimis safe harbor is not intended to prevent a taxpayer from reaching an agreement with its IRS examining agents that, as an administrative matter, based on risk analysis or materiality, the IRS examining agents will not review certain items. It is not intended that examining agents must now revise their materiality thresholds in accordance with the de minimis safe harbor limitations provided in the final regulation. Thus, if examining agents and a taxpayer agree that certain amounts in excess of the de minimis safe harbor limitations are not material or otherwise should not be subject to review, that agreement should be respected, notwithstanding the requirements of the de minimis safe harbor. However, a taxpayer that seeks a deduction for amounts in excess of the amount allowed by the safe harbor has the burden of showing that such treatment clearly reflects income.

REPAIRS [Reg. §1.162-4]

The repairs regulation is modified to specify that an item may only be taken as a repair to tangible property if the amounts are not otherwise required to be capitalized.

CAPITAL EXPENDITURES – GENERAL RULE [Reg. §1.263(a)-1]

The regulation provides the general rule for capitalization in Reg. §1.263(a)-1 (a), noting that except as otherwise provided for in Title 1 of the IRC no deduction will be allowed for:

- Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or
- Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Amounts paid to sell property, such as commissions and other transaction costs must be capitalized and treated as a reduction of the amount realized. The amount is taken into account in which the sale occurs or when the sale is abandoned if a loss is allowed. The capitalized amount does not add to the basis of the property, nor is it treated as an intangible under the intangible capitalization regulations of §1.263(a)-4. [Reg. §1.263-1(d)]

This provision is also effective for years beginning on or after January 1, 2014. Changes to comply with these provisions will be treated as a change in accounting method to which §§446 and 481 apply.

AMOUNTS PAID TO PRODUCE TANGIBLE PROPERTY [Reg. §1.263-2]

A taxpayer must capitalize amounts paid to "acquire or produce a unit of real or personal property" under this provision. Such items specifically include:

- Leasehold improvements;
- Land and land improvements;
- Buildings;
- Machinery;
- Equipment;
- Furniture and fixtures

The amount to be capitalized includes the invoice price, amounts paid to facilitate the acquisition or production of the property and costs for work performed prior to the date the unit of property is placed in service (even if such work would have been treated as a repair had the property been in service, per the preamble the regulations). The general capitalization rules extend to amounts paid to acquire tangible property for resale, or costs to produce such property. [Reg. §1.263(a)-2(d)(1)]

An amount is treated as paid to facilitate the acquisition of the property if it is paid in the process of investigating or otherwise pursuing the acquisition. [Reg. §1.263(a)-2(f)(1)] The following costs are deemed inherently facilitative under Reg. §1.263(a)-2(f)(ii):

- Transporting the property
- Appraisals (or other costs to determine the value or price of the property)
- Negotiation expenses
- Tax advice related to the acquisition
- Application fees, bidding costs or similar expenses
- Preparing documents for the acquisition process
- Examining and evaluating the title for the property
- Obtaining regulatory approval or securing permits
- Costs of conveying the property (such as sales taxes and title registration costs)
- Finders fees and brokers commissions
- Architectural, geological, engineering, environmental, or inspection services
- Services of a qualified intermediary or other facilitator of a §1031 exchange

However, for real property amounts paid to determine which real property to obtain or whether to acquire the property are not considered an inherently facilitating amount. [Reg. §1.263(a)-2(f)(2)(iii)] Similarly, amounts paid for employee compensation and overhead are also treated as amounts that do not facilitate acquisition of either real or personal property, although a taxpayer may elect to capitalize such amounts. [Reg. §1.263(a)-2(f)(2)(iv)]

Amounts paid to defend or perfect title to real or personal property are considered a cost of acquisition and must also be capitalized. [Reg. §1.263(a)-2(e)(1)]

Changes in the treatment of items by a taxpayer are considered a change of accounting method subject to IRC §§446 and 481.

AMOUNTS TO IMPROVE TANGIBLE PROPERTY [REG. §1.263(a)-3T]

Generally a taxpayer must capitalize expenses paid to improve a unit of property owned by the taxpayer. [Reg. §1.263(a)-3(d)] A unit of property is improved if the amounts paid:

- Result in a betterment of the property
- Restore the unit of property
- Adapt the unit of property to a new or different use

A unit of property is defined in Reg. §1.263(a)-3(e). Generally, each building and its structural components are treated as a single unit of property. For such buildings, an amount is to be treated as an improvement if the amount paid results to an improvement in any of the following:

- Building structure
- Building systems:

- HVAC systems
- Plumbing systems
- Electrical systems
- Escalators
- Elevators
- Fire protection and alarm systems
- Security systems
- Gas distribution systems
- Other structural components identified by the IRS in published guidance [Reg. §1.263(a)-3(e)(2)]

In the case of the owner of a condominium or cooperative, the unit of property is that portion of the building the taxpayer owns (for a condominium) or has rights to possess (in a cooperative). [Reg. §1.263(a)-3(e)(2)(iii), (iv)]

For property other than a building, generally, subject to the specified exceptions in the regulation, all the components that are functionally interdependent constitute a single unit of property. Functional interdependence is defined by looking at whether the placing of in service of one component is dependent on placing in service another component. [Reg. §1.263(a)-3(e)(3)(i)]

The "specially defined" units are listed below:

Plant Property – Such property is compromised of functionally interdependent machinery or equipment, other than network assets (defined next), used to perform an industrial process. In determining a unit of property in this case, the functionally interdependent group must be further subdivided, going beyond the general rule. In this case, the unit is each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent group. [Reg. §1.263(a)-3(e)(ii)]

Network Property – This property is narrowly defined to include "railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries." However, it excludes any item that would be considered a building structure or building systems under the regulation, as well separate property adjacent to, but not a part of, the network asset. The determination of a unit of property in these cases is based on the taxpayer's particular facts and circumstances (unless the IRS provides overriding published guidance). The functional interdependence test does not serve to determine the unit of property for this type of asset. [Reg. §1.263(a)-3(e)(iii)]

Leased Property Other Than Buildings – The general rule or, if applicable, one of the two special rules above, will apply to such property but with the caveat that the unit of property may not be larger than the unit of leased property. That is, the leased property could end up being multiple "units" of property under the regulations, but the property itself may not be incorporated into other property to determine a unit of property. [Reg. §1.263(a)-3(e)(iv)]

Regardless of the above rules, a component of a unit of property must be treated as separate units of property if the property belongs to a different MACRS class of property or the taxpayer had depreciated the component using a different method of depreciation than was used on the unit of property of which the component is a part. Similarly, if the taxpayer or IRS changes the determination of the MACRS class of property for the component in a later tax year, the component must be separated from the unit of property of which it was a part of and treated as a separate unit of property. [Reg. §1.263(a)-3(5)]

Special rules apply to improvements to leased property, as noted below:

> Lessee Improvements – A lessee must capitalize the total amounts it pays to improve a unit of leased property unless IRC §110 (related to construction allowances) applies to the item or where the payment for the improvement constitutes a substitute for rent pursuant to Reg. §1.61-8(c). The lessee must also capitalize the amount the lessor pays to improve a unit of leased property if the lessee is the owner of the improvement except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement. The amount capitalized as a lessee improvement is a unit of property separate from the leased property. However any later expenditure to improve the leasehold improvement itself is not a separate unit of property, but rather is considered part of the leasehold improvement under the unit of property rules. [Reg. §1.263(a)-3(f)(1)]
>
> Lessor Improvements – A lessor must capitalize amounts it pays to improve a unit of leased property (either directly or via a construction allowance) where the lessor is the owner of the improvement or to the extent that IRC §110 applies to the construction allowance. The lessor must also capitalize an improvement to the property paid for by the lessee that is a substitute for rent under Reg. §1.61-8(c). [Reg. §1.263(a)-3(f)(1)(iii)(A)] An amount capitalized by the lessor is not treated as a unit of property separate from the leased property. [Reg. §1.263(c)-3(f)(1)(iii)(B)]

Generally a taxpayer must capitalize all direct costs of an improvement and indirect costs that directly benefit or are incurred by reason of an improvement, using the uniform capitalization rules of §263A. Other costs, such as indirect costs that do not directly benefit and are not incurred by a reason of an improvement are not to be capitalized. An elective exception exists for property used as a residence. For such property not used in the taxpayer's trade or business and not held for the production of income, an individual may capitalize amounts paid for repairs and maintenance that are made at the same time as capital improvements to the residence if paid as part of a remodeling of the taxpayer's residence. [Reg. §1.263(a)-3(f)(3)]

A single improvement may be the aggregate of related amounts incurred over a period of more than one taxable year. Such a determination of individual improvements is made based on the facts and circumstances of the situation. [Reg. §1.263(a)-3(f)(4)]

A safe harbor is provided for routine maintenance on property other than buildings in Reg. §1.263(a)-3(g). Such maintenance will be deemed not to improve that unit of property. Routine maintenance includes the inspection, cleaning, and testing of the unit of property and replacement of parts of the unit of property with comparable and commercially available and reasonable replacement parts. To be considered such routine maintenance, the taxpayer has to expect to perform these services more than once during the class life (determined for purposes of the alternative depreciation system) of the property in question. [Reg. §1.263(a)-3(g)]

Regardless of the above, routine maintenance does not include any of the following:

- Amounts paid for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under § 1.165-7).
- Amounts paid for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component.

- Amounts paid for the repair of damage to a unit of property for which the taxpayer has taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165.
- Amounts paid to return a unit of property to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use.
- Amounts paid for repairs, maintenance, or improvement of rotable and temporary spare parts to which the taxpayer applies the optional method of accounting for rotable and temporary spare parts under § 1.162-3T(e). [Reg. §1.263(a)-3T(g)(3)]

The final regulations also add a provision for a small taxpayer building *de minimis* rule. For a taxpayer with average gross receipts for the prior 3 years of less than $10 million, if the total amount of maintenance type expenses on a building for the year is less than the lesser of $10,000 or 2% of the unadjusted basis of the building, the taxpayer will not have to make a determination regarding whether any of those expenses are an improvement if the taxpayer elects to use this option. The election limited to buildings with an unadjusted basis of $1,000,000 or less, and it's an all or nothing situation—all such expenses, even if otherwise not required to be capitalized, must be totaled to see if an election is possible. If the total goes above the limit, then the taxpayer must use the other provisions of the regulations to determine whether any of the expenditures must be capitalized.

Generally a taxpayer must capitalize amounts that result in a betterment of the unit of property as defined in Reg. §1.263(a)-3(h). An amount paid results in a betterment only if the expenditure:

- Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;
- Results in a material addition (including a physical enlargement, expansion, or extension) to the unit of property; or
- Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property. [Reg. §1.263(a)-3(h)(1)]

For real property, a betterment occurs if there is an improvement in either the building structure or any of the enumerated building systems noted above, even if there is not a betterment in the building taken as a whole. [Reg. §1.263(a)-3(h)(2)]

The determination of whether there has been a betterment is based on the overall facts and circumstances of the situation. Factors to consider include:

- Purpose of the expenditure
- Physical nature of work performed
- Effect of the expenditure on the unit of property

As well, other factors that appear relevant in the particular case should also be considered. [Reg. §1.263(a)-3(h)(3)(i)]

If a taxpayer is unable to obtain a comparable replacement part (due to technological advancements, product improvements, etc.), the mere fact that the part is replaced with an improved part will not, by itself, cause an expenditure to be treated as a betterment of the property. [Reg. §1.263(a)-3(h)(3)(ii)]

If a particular event (such as the failure of a part) necessitates the expenditure, a comparison to determine if a betterment has taken place is made by comparing the condition of the property immediately after the expenditure with that immediately before the circumstance triggering the need for the expenditure. If that event was normal wear and tear, the comparison is made to the property immediately after either the last time the maintenance for wear and tear was performed or, if such maintenance has not previously taken place, with the condition of the property when placed in service by the taxpayer. [Reg. §1.263(a)-3(h)(3)(iii)]

Expenditures to restore a unit of property must be capitalized. For purposes of these rules an amount is paid to restore a unit of property only if it:

- Is for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under § 1.165-7);
- Is for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- Is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165;
- Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;
- Results in the rebuilding of the unit of property to a like-new condition after the end of its class life; or
- Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property. [Reg. §1.263(a)-3(i)(1)]

As with betterments, with restorations of buildings the rules are applied to either the building structure or any of the enumerated building systems, with a restoration of either having to be capitalized. [Reg. §1.263(a)-3 (i)(2)]

Restoration to a "like-new" condition occurs if the unit of property is brought to "the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications." [Reg. §1.263(a)-3(i)(3)]

The test or replacement of a major component or substantial part of a unit of property is a facts and circumstances test, including both the qualitative and quantitative significance of the replaced component(s) in relation to the unit of property taken as a whole. A major component or structural part "includes a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a discrete and critical function in the operation of the unit of property." [Reg. §1.263(a)-3(i)(4)]

Adapting a property to a new or different use involves an adaption that "is not consistent with the taxpayer's intended ordinary use of the unit of property at the time originally placed in service by the taxpayer." Again for buildings this test is applied to the building structure and any of the building systems separately. [Reg. §1.263(a)-3(j)]

Taxpayers subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface Transportation Board (STB) may elect to use the optional regulatory accounting method. A taxpayer must use this method for determining capitalized expenditures as opposed to repair expenditures for all property subject to the regulatory accounting rules and bases the determination on the position taken for regulatory accounting purposes. [Reg. §1.263(a)-4(k)]

The IRS has also reserved to itself the ability to outline new repair allowance methods by publishing them in the Federal Register or in an Internal Revenue Bulletin. [Reg. §1.263(a)-4(l)]

The temporary regulation applies to taxable years beginning on or after January 1, 2012 [Reg. §1.263(a)-4(p)]. The items covered in this regulation are methods of accounting subject to IRC §§446 and 481. Taxpayers changing their accounting methods to comply with this regulation will need to obtain the consent of the IRS to the change of method.

Conforming changes are made to the regulations under §§168 and 263A to take into account this guidance.

Each of the regulations have numerous examples illustrating the applications of the provisions. Taxpayers should review those examples as they attempt to implement this new capitalization vs. expense regulation. As well, taxpayers need to review what changes, if any, need to be made to capitalized assets and/or their own capitalization procedures to comply with the new regulation.

JULY 2014 REVISIONS

The IRS made some minor changes to the regulations in July 2014, primarily to clarify the election to capitalize materials and supplies that otherwise could be expensed. That election, found at Reg. §1.162-3(d)(3), was clarified to:

- Change the wording for electing to capitalize. The original regulation said the election could be made by capitalizing the cost of the item and beginning to recover the cost. The IRS decided that "depreciate" was more appropriate than "recover" and the word has been changed.
- The revision also clarifies that this election is not available if an asset is acquired and disposed of in the same year.

ACCOUNTING METHOD CHANGE

In early 2014 the IRS updated the automatic accounting method change Revenue Procedure to deal with a portion of these revisions, modifying Revenue Procedure 2012-19 which previously had implemented method changes for the temporary regulations.

Revenue Procedure 2014-16 (http://www.irs.gov/pub/irs-drop/rp-14-16.pdf) provides updated relief for method changes. The Procedure also added new automatic change provisions for taxpayers to change from using UNICAP methods under §263A for real property acquired via a foreclosure proceeding or deed-in-lieu of foreclosure transaction. In Legal Advice Memorandum AM2013-001 the IRS had concluded that such lender acquired OREO (other real estate owned) was not subject to the UNICAP rules.

The procedure also contains an extension of time for electric transmission and distribution companies to apply the safe harbor method of accounting described in Revenue Procedure 2011-43 through the fourth taxpayer year ending after December 31, 2010. Previously the automatic change only applied for two taxable years ending after December 31, 2010.

Automatic accounting method changes are requested at the time the tax return is filed by completing Form 3115 in duplicate. One copy is sent to the designated IRS office (in this case Ogden, Utah) and the second copy is attached to the tax return for the year in question. Any necessary cumulative adjustment will be recovered under the standard rules found in IRC §481(a)—normally ratably over four years (beginning with the year of change) if the change is an addition to income and in the year of change if the change results in a decrease in cumulative income.

Section: 263A
IRS Issues Memorandum to Examination on Certain Mixed Service Cost Allocations of Utilities for Self-Constructed Property

Citation: Large Business & International Memorandum LB&I-04-0814-007, 10/14/14

In LB&I Memorandum LB&I-04-0814-007 the IRS addressed issues related to determining if certain utilities (electric utilities, natural gas utilities, and combined electric and natural gas utilities) have an appropriate method for allocating mixed service costs under §263A.

The memorandum notes that such taxpayers may not use the Simplified Service Cost Method to allocate mixed service costs to "self-constructed property that is not mass-produced or does not have a high degree of turnover." A taxpayer is required, rather, to use a reasonable method to account for such costs.

The ruling first provides a "safe harbor" of sorts, as agents are directed not to challenge the following method if a taxpayer is using it:

a. **Step 1 - A consistent headcount ratio** - The taxpayer allocates MSC among (i) transmission and distribution (T&D) and other departments, and between (ii) capital (i.e., production or resale) and non-capital activities within a T&D department based on an annually determined headcount ratio that is calculated in the following manner:

(i) The taxpayer categorizes total MSC among company-wide MSC, MSC attributable to deductible service departments, and MSC attributable to other non-company-wide departments (e.g., fleet, stores, engineering, electric transmission and distribution (Electric T&D), natural gas transmission and distribution (Gas T&D), and generation);

(ii) The taxpayer allocates the company-wide MSC between capitalizable MSC and non-capitalizable MSC within the various departments based on a company-wide headcount ratio; and

(iii) The taxpayer allocates the non-company-wide MSC between capitalizable MSC and non-capitalizable MSC within the various departments based on a headcount ratio method that is consistently applied for the various departments. The denominator for a non-company-wide department's capital/non-capital allocation ratio includes only those department employees who actually benefited from the MSC being allocated. The non-capitalizable MSC are treated as deductible MSC, and the capitalizable MSC are further allocated between inventory and self-constructed property based on the production cost ratio calculated in step 2.

b. **Step 2 - A production cost ratio with a limited reduction for purchased electricity and purchased natural gas** - The taxpayer allocates capitalizable MSC among capital activities according to a production cost ratio that is computed as follows:

(i) **Numerator** - The numerator equals the total Section 263A costs of self-constructed property of both Electric T&D and Gas T&D, less all MSC capitalized, less the interest capitalized to Electric T&D and Gas T&D self-constructed property .

(ii) **Denominator** - The denominator equals the total Section 263A costs of Electric T&D and Gas T&D self-constructed property, plus the Section 263A costs of electricity and natural gas sold, less 50 percent of the cost of the taxpayer's purchased electricity and purchased natural gas, less all MSC capitalized, less the interest capitalized to Electric T&D and Gas

T&D self-constructed property. The denominator of the production cost ratio does not include depreciation expense and does not include the cost of purchased electricity or gas sold outside the taxpayer's service area (e.g., non-native load).

(iii) **Application** - The production cost ratio is then multiplied by capitalizable MSC to arrive at the amount of MSC to be allocated to Electric T&D and Gas T&D self-constructed property. The remaining capitalizable MSC is allocated between electricity and natural gas inventory based on a reasonable cost ratio.

(iv) **Reductions for temporary solutions** - The use of the headcount ratio and the production cost ratio takes into consideration the amount of costs that may have been capitalized to temporary solutions. Therefore, further reductions in the amount capitalized for temporary solutions should not be made.

The memorandum goes on to note, however, that this guidance does not apply if a taxpayer includes any of the following elements in its allocation of mixed service costs:

- Additional costs of working in an energized environment treated as costs of maintaining electric service
- Overly broad or other inappropriate cost drivers
- Imputation of production costs based on hypothetical events

As well, the directive does not address the following "threshold" issues:

Whether a particular cost is a mixed service cost, as defined in § 1.263A-1(e)(4)(ii)(C); or

Whether a department is a service department that generates both capitalizable service costs, as defined in § 1.263A-1(e)(4)(ii)(A), and deductible service costs, as defined in § 1.263A-1(e)(4)(ii)(B) (i.e., is a mixed service department).

Section: 263A
Restaurant's Application of Provisions of §263A Discussed in National Office Memorandum

Citation: CCA 201439001, 9/26/14

The UNICAP rules of IRC §263A have sometimes been referred to as the "fuller absorption" method of allocating inventory costs since they attach costs beyond those normally taken into inventory in ending inventory. The rules are far reaching and impact producers and resellers.

In Chief Counsel Advice 201439001 the Chief Counsel's office looks at the application of §263A to restaurants.

Clearly restaurants do produce goods, though inventory on hand generally consists almost exclusively of ingredients that have not be "assembled" into the menu items by the kitchen staff. The memo arose because the IRS, in auditing some restaurants, discovered that they were treating the amounts paid to kitchen staff as being immediately subject to expense and not treated as part of direct inventory costs (or, effectively, §471 costs for IRC purposes) nor as expenses subject to §263A's provisions.

The wording of the memorandum suggests that agents in question were wishing to put such restaurants on the simplified production method under Reg. § 1.263A-2(b). Under that method §263A costs are allocated to ending inventory using the following formula:

$$\frac{\S 471 \text{ inventory costs in ending inventory}}{\S 471 \text{ inventory costs incurred during year}} \times \text{Total } \S 263\text{A Costs}$$

Alternatively a taxpayer may develop a "facts-and-circumstances" method to allocate §263A costs to ending inventory.

Clearly putting the restaurant on the simplified production method would result in a portion kitchen staff costs ending up being allocated to the ending inventory with deduction delayed until the following year. That would be true despite the rather obvious fact that, in most cases, virtually all of the kitchen staff's efforts were directed at creating the food that was consumed by customers rather than the ingredients that might be sitting in storage at the end of the year.

The memorandum recognizes this fact, holding that the National Office would not support agents requiring such restaurants to use the simplified production method to account for these costs. While acknowledging the use of such a method is allowed, the memorandum suggests that if a restaurant proposes an alternative accounting method change such as treating such items as §471 costs (in which case they would clearly end up in the cost of food served to customers—and thus not in inventory) or by developing a "facts and circumstances" test (perhaps allocating such expenses so only the time for individuals who are involved in managing a stockroom would end up with §263A costs) the National Office would support allowing the taxpayer to make use of these methods.

Section: 263A
Final Regulations Issued Regarding Proper Treatment of Sales-Based Royalties and Certain Vendor Allowances

Citation: TD 9652, 1/13/14

The IRS issued final regulations early in 2014 regarding the treatment of sales-based royalties and vendor allowances in TD 9652 (http://www.gpo.gov/fdsys/pkg/FR-2014-01-13/pdf/2014-00327.pdf). The IRS modified three regulations under IRC §263A (Regs. §§1.263A-1, 2 and 3) as well as one regulation under IRC §471 (Reg. §1.471-3).

The regulations were issued in proposed form in 2010 (REG-149335-08) and the final regulations made certain changes.

Sales based royalties are royalties incurred only upon the sale of property produced or acquired for resale. A sale-based vendor allowance is an allowance, discount or price rebate that a taxpayer earns by selling merchandise.

A company paying a sales based royalty was, under the proposed regulations, to have been required to treat such amounts paid as related only to the cost of goods sold. Thus, regardless of the taxpayer's cost flow assumption (FIFO, LIFO, etc.) such costs could not end up in the taxpayer's inventory at the end of the year. Some commentators expressed concern that this might prove burdensome to taxpayers using simplified allocation methods.

The final regulations make such an allocation of royalties solely to cost of sales only as one possible method. Under the final regulations a taxpayer may allocate the royalties:

- Entirely to cost of sales, as provided in the proposed regulations

- Allocated between cost of goods sold and ending inventory using either:
  - A facts and circumstances method described in Reg. §1.263A-1(f) *or*
  - One of the two simplified methods (simplified production method described in Reg. 1.263A-2(b) or simplified resale method described in Reg. §1.263A-3(d))

Under the proposed regulations the recipient of a sales-based vendor allowance would have been required to treat such an allowance as a reduction in the cost of sales, again not impacting ending inventory. Commentators complained that given the nature of many such arrangements, this treatment would often be inappropriate.

For instance, in some cases a vendor will receive a reduced price for each unit purchased during the year once the sales target is reached or even simply a reduction in additional units purchased during that period. In both cases a portion or all of the reduction would be allocable to goods not sold at the time the allowance is triggered. The final regulations generally remove the requirement to charge the entire allowance against cost of goods sold, so that a proper allocation generally is subject to a facts and circumstances analysis. The preamble notes that the IRS is now considering alternative treatments for such cases.

However, the regulations continue to require full inclusion as a reduction of cost of sales, with none being allocated to inventory. "Sales-based vendor chargebacks" are defined to be "an allowance, discount, or price rebate that a taxpayer becomes unconditionally entitled to by selling a vendor's merchandise to specific customers identified by the vendor at a price determined by the vendor." The preamble notes that such a payment is meant to insure the taxpayer is protected and will not realize a loss on the sale.

Any allowance, discount or price rebate of this type must be taken directly against cost of sales.

The final regulations are effective for taxable years ending on or after January 13, 2014.

Section: 263A
Stamp Taxes Could Not Be Subtracted From Receipts to Determine Qualification for Small Reseller Exception to §263A

Citation: City Line Candy & Tobacco Corp. v. Commissioner, 141 TC No. 13, 11/19/13

If a taxpayer collects a tax and then passes it on to the consumer, may it exclude that tax from its gross receipts for purposes of the small reseller exemption under IRC §263A's uniform capitalization provisions? That was the issue before the court in the case of City Line Candy & Tobacco Corp. v. Commissioner, 141 TC No. 13, http://www.ustaxcourt.gov/InOpHistoric/CityLineCandyDiv.Marvel.TC.WPD.pdf.

The taxpayer was a wholesaler of cigarettes in New York. Under New York state law the taxpayer purchased tax stamps to affix to the cigarettes it sold. State law required that the taxpayer include the cost of such stamps in the price charged to any consumer after they were affixed to the packs of cigarettes.

For financial statement purposes, the corporation reported as gross sales the total amount it charged to the retailers it sold to. However, for income tax purposes the taxpayer reduced the gross receipts by the approximate cost of the stamps and removed any deduction for stamps purchased.

With the taxes included in gross revenues, the taxpayer's average gross receipts for the prior three years exceeded $10,000,000. With the taxes removed, the average was well below $10,000,000. This becomes important since a reseller with average gross receipts of less than $10,000,000 for the prior three years qualifies for the small reseller exception to the IRC §263A uniform capitalization rules.

The taxpayer argued that state law imposed the tax on the consumer and, as such the amount did not represent gross receipts for the small reseller test. The Tax Court found otherwise.

The Court noted that the taxpayer reported the amounts as part of its gross receipts on its financial statements, only netting the amount for tax reporting. As well, the Court found that New York law, while imposing ultimate liability on the consumer, also imposed liability on the reseller based on state case law. Thus the Court found the corporation was not eligible for the small reseller exception and was required to use the uniform capitalization rules found at IRC §263A.

Section: 274
Auto Mileage Rates for 2015 Published by IRS

Citation: Notice 2014-79, 12/10/14

The IRS released the mileage rates for 2015 in Notice 2014-79 and News Release IR-2014-114. The standard business rate is set at 57.5 cents per mile. The charitable mileage rate is set at 14 cents per mile. The standard mileage rate for medical care under §213 or for moving under §217 is set at 23 cents per mile.

The portion of the standard mileage rate treated as depreciation for an automobile used for business is 21 cents for 2009, 23 cents for 2010, 22 cents for 2011, 23 cents for 2012, 23 cents for 2013, 23 cents for 2014 and 24 cents for 2015.

For purposes of computing the allowance under a fixed and variable rate allowance, the standard automobile cost for 2015 may not exceed $28,200 for automobiles and $30,800 for trucks and vans.

In the news release the IRS reminds taxpayers that the standard business mileage rate may not be used for a vehicle when the taxpayer had previously claimed accelerated depreciation or §179 expensing for the vehicle, nor may it be claimed on more than four vehicles.

Section: 274
Law Firm's Failure to Document Travel Expenses and Be Sure to Have Law Firm Pay Expenses (Rather Than Shareholder) Costs Firm Over $3,000,000 in Deductions

Citation: Engstrom, Lipscomb & Lack, APC v. Commissioner, TC Memo 2014-221, 10/20/14

In the case of *Engstrom, Lipscomb & Lack, APC v. Commissioner*, TC Memo 2014-221, the taxpayer had claimed travel expense deductions of over $4,300,000 for the years in question. However, by the time the Tax Court came to its conclusion, the allow amount of deductions had been reduced to just over $910,000 for the years in question—or less than ¼ of the original amounts claimed.

The key problem for the taxpayers was IRC §274(d) which provides for strict substantiation rules related to travel and certain other expenditures. The provision provides specifically:

> (d) Substantiation required.
>
> > No deduction or credit shall be allowed—
> >
> > > (1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),
> > >
> > > (2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity,

(3) for any expense for gifts, or

(4) with respect to any listed property (as defined in section 280F(d)(4)),

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. This subsection shall not apply to any qualified nonpersonal use vehicle (as defined in subsection (i)).

The key fact to note in the above provision is the absolute disallowance of a deduction unless the four required items of corroborating evidence exists. The provision was a Congressional attempt to limit the use of the *Cohan* doctrine in cases where Congress felt the nature of the expenditure required more detailed records be available.

In this case the main problem the taxpayers had related to documenting extensive travel paid to a partnership of which a 50% interest was held by a member of the law firm.

The big problem was the fact that while records were kept of the plane's flights, maintenance, etc., no records were generally kept regarding the nature of the business being conducted on the flights. The Tax Court generally disallowed all expenses (including ones for flights where other law firm employees came along) for which the documentation was lacking.

Similarly, for many of the expenses, the attorney himself paid personally for the flight charge to the partnership rather than having his law firm pay the costs. The attorney claimed that these were either loans or capital contributions and, therefore the corporations should be allowed a deduction.

However, there was no contemporaneous documentation of either a loan or capital contribution, which caused the Tax Court to disallow the deduction to the corporation due to the simple fact that the corporation never paid these expenses. As the Court noted "[w]e are disinclined to embrace after-the-fact, self-serving testimony as a substitute for actual contemporaneous evidence and documentation."

Aside from the amount of expenses disallowed, there's really nothing unusual in this case either about the loss of a §274(d) deduction due to lack of documentation, or the denial of deductions when the taxpayer doesn't have the entity incurring the expense actually make the payment. And, unfortunately, often busy clients (like the attorneys in this case) are the most difficult clients to convince that these details must be taken care.

However, as this case points, failing to take care of such details means failing to obtain the deductions the taxpayer would otherwise be entitled to.

Section: 274
IRS Publishes Revised Special Per Diem Rates for Period from October 1, 2014 to September 30, 2015

Citation: Notice 2014-57, 9/22/14

The IRS in Notice 2014-57 provided updated special per diem effective for the period from October 1, 2014 to September 30, 2015. These special rates include the rate for the special transportation industry meals and incidental expenses (M&IE) rate, the rate for the incidentals-only deduction and the rates and list of high-cost localities for purposes of the high-low substantiation method.

The special transportation industry rates for 2014-2015 are $59 for any locality of travel in the continental United States and $65 for any locality of travel outside the continental United States. The general rules for qualifying to use these rates and how to use them are found in Section 4.04 of Revenue Procedure 2011-47.

The incidentals only rate for 2014-2015 is set at $5. The provisions applicable to using this rate are found in Section 4.05 of Revenue Procedure 2011-47.

The high-low rates for 2014-2015, to be used in lieu of the rates described in Notice 2013-65, are $259 for any high-cost locality and $172 for travel to any other locality within the continental United States. The portion of the above amounts treated as paid for meals are $65 for travel to a high-cost locality and $52 for any other location within the continental United States.

Section 5.2 of the notice provides the 2014-2015 list of high-cost localities. Some localities are high-cost only for a portion of the year, with this fact noted in the listing.

Section: 274
IRS Revises Contractor Meals and Entertainment Expense Reimbursement Provisions

Citation: TD 9625, 8/1/13

In Treasury Decision TD 9625 (https://federalregister.gov/a/2013-18559) the IRS released revisions to Reg. §1.274-2 that modified the treatment of reimbursed food, beverage and entertainment expenses. The newly revised provision describes the treatment of employees and those who are not employees, looking at which party will bear the burden of the disallowance of 50% of the expenditure under §274(n)(1)

Under Reg. §1.274-2(f)(2)(iv)(B), an employee will bear the 50% disallowance if the employer treats the entire payment as compensation to the employee both on its income tax return and for purposes of withholding (and thus W-2 reporting) to the employee. In that case the employee would end up having to deduct the expense, subject to the ½ disallowance, on Form 2106.

In the more normal case where the payment is made under an accountable plan pursuant to IRC §62(a)(2)(A) which complies with the requirements found in IRC §62(c), the employer will bear the burden of the disallowance under IRC §274(n)(1).

Payments to those other than employees is governed by Reg. §1.274-2(f)(2)(iv)(C). If the parties have an agreement with regard to which party shall bear the disallowance, then that agreement will control. In the absence of such an agreement, if the contractor fully accounts for the expense and separately bills the item, than the customer would end up with the disallowance. Otherwise, the contractor must bear the burden of the loss of ½ of the deduction.

The major change compared with the prior version of the regulation is the ability of contractors and customers to come to a separate agreement with regard to who shall bear the burden under Reg. §1.274-2(f)(2)(iv)(C). Thus, a contractor can be reimbursed for such expenses after a full accounting to the customer, but nevertheless still agree to bear the burden of the disallowance.

The new regulations will apply to expenses paid or incurred in taxable years beginning after August 1, 2013.

Section: 280F
IRS Announcing Depreciation and Lease Inclusion Amounts on Vehicles for 2014

Citation: Revenue Procedure 2014-21, 2/25/14

In Revenue Procedure 2014-21 (http://www.irs.gov/pub/irs-drop/rp-14-21.pdf) the IRS released the limits on depreciation for vehicles subject to the limitations of §280F(d)(7)(B)(i) for items placed in service in 2014.

One major change over the tables for 2013 reflects the expiration of the bonus depreciation provisions found at IRC §168(k) at the end of 2013. It remains to be seen if Congress will restore the bonus depreciation provisions which under under prior law increased the limits by $8,000 in the first year for vehicles that met the other requirements under IRC §168(k).

The limits (for now) are as follows:

REV. PROC. 2014-21 TABLE 1 **DEPRECIATION LIMITATIONS FOR PASSENGER AUTOMOBILES (THAT ARE NOT TRUCKS OR VANS) PLACED IN SERVICE IN CALENDAR YEAR 2014**:	
Tax Year	Amount
1st Year	$3,160
2nd Year	$5,100
3rd Year	$3,050
Each Succeeding Year	$1,875

REV. PROC. 2014-21 TABLE 2 DEPRECIATION LIMITATIONS FOR TRUCKS AND VANS PLACED IN SERVICE IN CALENDAR YEAR 2014:	
Tax Year	Amount
1st Year	$3,460
2nd Year	$5,500
3rd Year	$3,350
Each Succeeding Year	$1,975

The procedure also contains updated tables to be used for the lease inclusion amount under Reg. §1.280F for lease terms beginning in calendar year 2014.

Section: 311
Corporation Found Not to Have Transferred Goodwill to New Operation of Shareholders' Sons

Citation: Bross Trucking, Inc. v. Commissioner, TC Memo 2014 107, 6/5/14

In the case of *Bross Trucking, Inc. v. Commissioner*, TC Memo 2014-107, http://www.ustaxcourt.gov/InOpHistoric/BrossMemo.Paris.TCM.WPD.pdf, the Tax Court revisited an issue that has cropped up in numerous cases over the years—the question of goodwill held (or perhaps not held) by a corporation that the IRS argues has been distributed from the corporation.

The reason this is an important issue is due to IRC §311(b) which requires a corporation to recognize gain when it distributes property to a shareholder and that property's fair market value is greater than the basis of the asset in the corporation's hands. So while it may be possible get goodwill (or other intangible assets) into the corporation tax free from shareholders if IRC §351 applies, the reverse is not true—even if the asset has not appreciated one cent since being contributed by the shareholder.

As well, IRC §311(b) applies to both S and C corporations. Thus, unlike what is generally the case for a partnership, a distribution of such intangible assets from an S corporation will trigger immediate gain recognition if the fair value exceeds the basis of the asset.

But, it is important to note two key issues. First, the corporation must distribute property that it owns—if the corporation does not own the goodwill then it cannot distribute it. Second, the property must have worth in excess of the corporation's basis.

The best known case involving the first issue is the 1998 case of *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189. In that case, the Court found that the shareholder and not the company owned the goodwill in question. There the Court found the relationships that the shareholder had developed represented the entirety of the goodwill and, since there was no employment agreement restricting the shareholder's ability to compete against the entity, the shareholder was the owner of the goodwill.

Contrast that with the case of *Larry E. Howard v. United States*, CA9, 2011-2 USTC ¶50,602 where the shareholder did have an employment agreement with the corporation. In that case the Court found that Mr.

Howard could not have sold the goodwill since the corporation had control of the goodwill—thus it had to have been distributed to Larry before he could sell it, triggering gain recognition at the corporate level.

Similarly, goodwill doesn't have to be solely customer relationships. The Court notes the case of *Solomon v. Commissioner*, T.C. Memo. 2008-102 where the Court found the goodwill arose from the corporation's pigment operations, and thus again the goodwill could not be sold by the shareholders.

The case in front of the court now, while considering the issue of who owned the goodwill also considered whether there was actually any value. As well, unlike the other cases this one did not involve a sale of the enterprise, but rather the IRS claim that the shareholder had transferred the goodwill from his wholly owned corporation to a new corporation founded by his sons. Thus, in this case, the IRS claimed not only a taxable event under IRC §311(b) but also a taxable gift from the shareholder to his sons.

Note should be taken that there's nothing wrong with the IRS theory of the taxation of this transaction if (and it turns out to be a big if with the facts of the case) the corporation had goodwill and Dad managed to transfer that asset to a new entity controlled by his offspring. But it turns out the Court had trouble finding that both that the corporation had any ownership of such an asset and even, given the facts, that anyone truly had such an asset.

The IRS likely did not help its case by arguing that it did not have to separately identify each intangible asset transferred, though it claimed multiple types of assets were transferred. The Tax Court had a problem with this view since, as was noted above, §311(b) applies only to the transfer of assets.

The Tax Court decided to interpret the IRS position as being that the only asset transferred was goodwill, being that it's generally used for the concept of the "going concern" value associated with the business, which would include relationships and the like.

The Court noted that while it was possible the corporation had possessed goodwill from its operations, in the years prior to the transaction in question the Company had run afoul of regulators after being found to have violated various rules. The Company believed both that it was being unfairly harassed due its past sins and there was a serious possibility that the Company might be shut down by the regulators. This threat caused certain customers (who did happen to be held by parties related to the shareholder) to worry about whether other arrangements would need to be made.

The sons formed a new corporation to operate a new trucking company under a different name. The new corporation did take over some vehicles from the old company. Initially the new corporation put some of these vehicles on the road still displaying the old company's name, but it found the trucks were being hounded by regulators who saw the name, so the new company purchased magnetic signs to cover up the old company name on the vehicles until they were able to get them repainted.

The court noted that "[t]rade names and trademarks are the embodiment of goodwill" but in this case the new company went out of its way to hide any relationship with the old entity—thus, the Court concluded, there was no goodwill at the corporate level.

The Court found that what goodwill did exist arose from Mr. Bross's personal relationships and related items, all created by his work in the road construction industry. The court found that, as in the *Martin* case, "Bross Trucking's customers chose to patronize the company solely because of the relationships that Mr. Bross personally forged."

The Court noted that "[a] company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee." Such goodwill only becomes a corporate asset if the employee transfers it to the employer by agreeing to limit the use of that asset only for the benefit of the company, generally through an employment agreement or non-compete agreement. However, Mr. Bross (unlike Larry Howard noted above) did not have any such restrictive agreements with the old trucking company.

One final asset the court considered was the old company's workforce. However, the Court noted both that the trucking company used owner-operators primarily and that only about 50% of the employees the old company did have ended up working for the new company. Thus the Court did not find that a "workforce in place" intangible asset had been transferred.

Advisers need to both see the opportunities inherent in this ruling and, possibly more importantly, note that limitations of the ruling. Too often advisers read about cases like this in tax newsletters (or manuals like this one) and summarize it down to a simplistic one liner. This case does not lend itself to such a simplification.

The case does point out that if the only goodwill style asset are relationships that are held by a shareholder, the lack of an employment agreement or non-compete agreement means both that it is possible to sell the goodwill outside the corporation or move it to a new entity. Goodwill that is wholly relationship based exists most often in service enterprises (see the CPA firm the case of *Norwalk v. Commissioner*, T.C. Memo. 1998-279).

In such a case where there are few other assets, it would be possible to "disincorporate" tax free (say to move to a partnership structure). Similarly, a sale of the business may consist largely of payments to the shareholders who agree to transfer the goodwill to the buyer through agreements restricting their ability to make use of that goodwill.

The flip side of that is, as Dr. Howard discovered in his case, the existence of an employment agreement or similar restrictions on competing with the entity is fatal to an argument that goodwill was not transferred.

As well, the Court pointed out that there are other aspects to goodwill besides the relationships, such as a process like the one in *Solomon*. In such a case, the fact that no employment agreement exists will not mean that the corporation has no goodwill to transfer.

This case had rather unique facts that eliminated any corporate goodwill. If the old corporation had not run into the regulatory problems that it did, it's very possible the Court might have come to a different conclusion.

Section: 312
Change in Depreciation Taken Into Account for E&P Purposes Over Same §481(a) Period as for Regular Tax

Citation: PLR 201410029, 3/7/14

In PLR 201410029 (http://www.irs.gov/pub/irs-wd/14010029.pdf) the IRS explained how a taxpayer's change in accounting method for the depreciable life of an asset affects the corporation's earnings and profits.

The taxpayer in this case was looking to change the depreciable lives of various items of property, uniquely in this case lengthening the claimed lives—thus creating a net positive §481(a) adjustment that would be spread over 4 years under the standard tax computation.

Of course, the computation of depreciation also affects the calculation of a corporation's earnings and profits and, in this case, that longer life for regular tax purposes would also serve to generate a longer life for the computation of earnings and profits. But the question is—does the corporation end up recalculating the earnings and profits and, if it is adjusted, does the adjustment take place immediately or will it follow the four year phase in that is used for regular taxes under IRC §481(a).

The IRS cites Revenue Procedure 79-47 which holds that the taxpayer will compute an E&P adjustment in this case and take it into account ratably over the same four year §481(a) period as governs the regular tax depreciation.

Section: 362
Final Regulations Issues on §362(e)(2) Duplicate Loss Issues During §351 Transactions

Citation: TD 9633, 9/3/13

In TD 9633 (http://www.gpo.gov/fdsys/pkg/FR-2013-09-03/pdf/2013-21330.pdf) the IRS adopted final regulations regarding the "loss duplication" rules found in IRC §362(e)(2). These provisions are meant to prevent a taxpayer from effectively duplicating losses by transferring property with a built-in loss to a corporation as part of an IRC §351 incorporation transaction.

Under the general rules, if property had a basis of $100 and a fair value of $50 that was transferred in exchange for stock in a transaction subject to §351's provisions, the taxpayer would have stock with a basis of $100, and the corporation would have an asset with a basis of $100. In essence, both the corporation and the shareholder could each recognize the same "built-in" $50 loss—the corporation doing so when it sells the asset, and the shareholder doing so when he/she sells the stock.

Generally IRC §362(e)(2), enacted in 2004, requires the corporation to reduce its basis in the transferred asset in such a situation. Notice 2005-70 has provided interim rules dealing with such an election since that time, and these regulations modify and replace the rules in Notice 2005-70.

Under IRC §362(e), a taxpayer may elect, by attaching a "Section 362(e)(2)(C)" statement and complying with other requirements, to reduce the basis of the received stock rather than the basis of the asset in the corporation. Often this will be preferable, since it's more likely the corporation will be able to benefit sooner from the higher basis than will the shareholder.

The provisions for the election are found at Reg. §1.362-4(d). First, both the corporation and shareholder(s) must enter into a binding written agreement to elect to apply §362(e)(2)(C). Second, an election prepared in accordance with Reg. §1.362-4(d)(3) must be filed (normally by the transferor, but potentially by the acquiring corporation if the transferor is not required to file a U.S. tax return) by the due date (including extensions) of the applicable return and be included with that timely filed return.

The statement must:

- Identify (by name and tax identification number, if any) Transferor and Acquiring;
- State that Transferor and Acquiring have entered into a written, binding agreement to elect to apply section 362(e)(2)(C) as required in paragraph (d)(1)(i) of this section; and
- State the date of the transaction (or, if the transaction includes transfers on more than one date, then the dates of all transfers) to which the election applies.

Notice 2005-70 did not require the written agreement between the parties prior to the election. The IRS has granted relief from the late elections via the provisions found in the regulations under IRC §9100 for taxpayers who made late elections.

While the regulations do not discuss any potential relief, presumably (since this is a regulatory election) the IRS will continue to grant such consents for late elections if a taxpayer pays the applicable user fee and seeks a ruling granting such relief. As is always true with such relief, the taxpayer must demonstrate that such relief would not harm the interests of the government and that, generally, the relief is not being sought simply based on the advantage of now knowing how the tax burden will actually fall.

The regulations generally apply to transactions occurring after September 3, 2013. If a transaction takes place after that date pursuant to a binding agreement in effect prior to September 3, 2013, the regulations will not apply (and the taxpayer may instead look to Notice 2005-70) unless the taxpayer elects to have the final regulations apply. As well, a taxpayer may elect to apply these rules to any transactions that occurred after October 22, 2004 (the effective date of IRC §362(e)(2)).

Section: 368
Final Regulations Issues on Allocation of Basis in All Cash D Reorganizations

Citation: TD 9702, 11/12/14

The IRS has issued final regulations (TD 9702) detailing the allocation of basis in an all cash D reorganization under IRC §368(a)(1)(D). These regulations adopt, with some minor changes, temporary regulations issued by the IRS in 2011 to attempt to "clarify" the 2009 regulations that created the all cash D reorganization to deal with some taxpayers' interpretation of those rules.

As the preamble notes, a reorganization under IRC §368(a)(1)(D) (a D reorganization):

> …provides, in part, that a reorganization includes a transfer by a corporation (transferor corporation) of all or a part of its assets to another corporation (issuing corporation) if, immediately after the transfer, the transferor corporation or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the issuing corporation, but only if, in pursuance of the plan, stock or securities of the issuing corporation are distributed under section 354, 355, or 356.
>
> Under section 354(a)(1), a shareholder or security holder of the transferor corporation generally recognizes no gain or loss if the shareholder or security holder exchanges stock or securities of the transferor corporation, in pursuance of the plan of reorganization, solely for permitted property. Section 354(b)(1) provides that section 354(a)(1) is inapplicable to a D reorganization unless the issuing corporation acquires substantially all of the assets of the transferor corporation, and the stock, securities, and other properties received by the transferor corporation, as well as the other properties of the transferor corporation, are distributed in pursuance of the plan of reorganization. Further, section 356 provides, in part, that if section 354 would apply to an exchange but for the fact that property other than permitted property is also received, the recipient recognizes gain, but not in excess of the amount of money and fair market value of such other property.

In TD 9475, issued in December 2009, the IRS issued final regulations "providing that the distribution requirement of section 368(a)(1)(D) and 354(b)(1)(B) is satisfied in the case of an All Cash D reorganization even though there is no actual distribution of permitted property by the transferor corporation, provided the same person(s) own, directly or indirectly, all of the stock of the transferor and issuing corporations in identical proportions."

Under those regulations the issuing corporation is deemed to have issued a nominal share of stock in additional to the actual consideration. A taxpayer who receives the consideration plus that nominal share was allowed to assign basis in that share to any share of the issuing corporation the taxpayer held, after making the basis adjustments provided for in Regs. §§1.358-1 and 1.358-2.

The preamble notes that:

> Certain taxpayers had taken the position that a shareholder of a transferor corporation who did not own any actual shares of an issuing corporation's stock immediately after the section 354 or section 356 exchange in a value-for-value All Cash D reorganization was permitted to designate another person's share of the issuing corporation's stock as the share to which the nominal share's basis could attach.
>
> For example, assume that corporation P owns all of the stock of corporations S1 and S2, and that S1 owns all of the stock of corporation S3. If S3 (the transferor corporation) transfers to S2 all of its assets (subject to liabilities) having a value of $100x in exchange for $100x of cash, S2 (the issuing corporation) would be deemed to issue a nominal share of its stock to S3 under §1.368-2(l)(2), provided the transaction otherwise qualified as a D reorganization. S3 would then be deemed to distribute the nominal S2 share to S1 in the section 356 exchange.
>
> Because S1 received a nominal S2 share but did not actually own any S2 stock, §1.368-2(l)(2) would require that the nominal S2 share be treated as distributed by S1 to P to reflect the actual ownership of S2 and P's basis in the nominal share would be its fair market value under section 301(d).
>
> In an attempt to avoid this result under similar circumstances, certain taxpayers took the position that S1 was permitted to, after allocating the basis of its S3 stock to the nominal S2 share under the rules of §§1.358-1 and 1.358-2, designate a share of S2 stock that was actually held by P to which S1's basis in the nominal S2 share would attach. These taxpayers further took the position that such designation and allocation could occur immediately before the nominal S2 share was deemed (under §1.368-2(l)) to be further transferred through the chain of ownership to reflect the actual ownership of S3 and S2.
>
> Under this interpretation, any built-in loss in the shares of transferor corporation stock (which the 2009 regulations allocated to the nominal share of issuing corporation stock) would be preserved even if a direct shareholder of the transferor corporation did not directly own stock of the issuing corporation. Taxpayers could thus avoid losing the built-in loss in the nominal share, which may have occurred as a result of the deemed transfer(s) of the nominal share through the chains of ownership to the actual shareholder(s) of the issuing corporation. In addition, the actual shareholder could then sell the share of the issuing corporation's stock to which the nominal share's basis was allocated and recognize a loss or a reduced amount of gain.

The IRS did not believe this an appropriate interpretation of these rules and, in 2011 issued temporary regulations to change this result.

> Specifically, the temporary regulations provided that, using the facts of the example described earlier in this section, because P (an actual shareholder of S2 (the issuing corporation)) is deemed to receive a nominal share of S2 stock described in §1.368-2(l), P must, after allocating and adjusting the basis of the nominal S2 share in accordance with the rules of §§1.358-1 and 1.358-2, and after adjusting the basis in the nominal S2 share for any transfers described in §1.368-2(l) (that is the transfer from S3 to S1 and from S1 to P), designate the share of S2 stock actually held by P to which the basis, if any, of the nominal S2 share will attach.
>
> The purpose of the temporary regulations was to clarify that only a shareholder that owned actual shares of the issuing corporation's stock immediately after a value-for-value All Cash D reorganization could designate one of its actual shares of the issuing corporation's stock to which the nominal share's basis, if any, would attach.

The IRS has now adopted these regulations as final regulations, making what the Service calls clarifying, but not substantive, changes to the regulations.

The IRS first notes the following change:

> The changes to newly designated §1.358-2(a)(2)(iii)(A)(1) and (2) were made to clarify that the deemed recapitalization under the second step of the bargain exchange basis rule occurs only after the stock treated as issued by the issuing corporation pursuant to §1.368-2(l) is held by a shareholder that actually owns issuing corporation stock. Thus, using the facts of the example described in section 4 of this preamble, except that the consideration provided by S2 is not $100 of cash but only $90 of cash, because S1 (the shareholder of S3 (the transferor corporation)) does not actually own any stock of S2 (the issuing corporation), the basis of the S2 stock treated as issued under the first step of the bargain exchange basis rule that S1 receives in the section 356 exchange is determined under §§1.358-1 and 1.358-2 (without regard to the second step of the bargain exchange basis rule or the nominal share basis designation rule) and then further adjusted for the transfer to P described in §1.368-2(l) prior to the deemed recapitalization of the stock of S2 that P actually holds and is deemed to hold.

The IRS next discusses the following change:

> The numbering changes reflected in newly designated §1.358-2(a)(2)(iii)(A)(1), (2) and (B) were made to clarify that the nominal share basis designation rule applies in cases in which a nominal share of issuing corporation stock is deemed issued under §1.368-2(l). Additional changes were made under §1.358-2(a)(2)(iii) to emphasize that the nominal share basis designation rule applies only after an actual shareholder of the issuing corporation receives the nominal share pursuant to §1.368-2(l), and that such a shareholder must attach the nominal share's basis to a share of the issuing corporation's stock that the particular shareholder actually owns.

Finally, the IRS discusses the following:

> In addition, the analysis of Example 16 of §1.358-2(c) has been clarified to confirm that Corporation P must designate a share of Corporation Y stock to which the distributed nominal share's zero basis will attach. This designation of the share to which the basis of a nominal share must attach is relevant in various scenarios, including if an affiliated group files a consolidated return and must determine the particular share that is a successor asset for purposes of §1.1502-13. Finally, minor editorial changes were made to reflect the new paragraph designations under §1.358-2(a)(2)(iii) and to make Examples 15 and 16 of §1.358-2(c) consistent with the clarifying changes adopted by the final regulations.

The revised examples 15 and 16 read as follows:

> Example 15. (i) Facts. Each of Corporation X and Corporation Y has a single class of stock outstanding, all of which is owned by J, an individual. J purchased 100 shares of Corporation X stock on Date 1 for $1.50 each, resulting in J having an aggregate basis in the stock of Corporation X of $150. On Date 2, Corporation Y acquires the assets of Corporation X for $100 of cash, their fair market value, in a transaction described in §1.368-2(l). Pursuant to the terms of the exchange, Corporation X does not receive any Corporation Y stock. Corporation X distributes the $100 of cash to J and retains no assets.
>
> (ii) Analysis. Pursuant to §1.368-2(l), Corporation Y will be deemed to issue a nominal share of Corporation Y stock to Corporation X in addition to the $100 of cash actually exchanged for the Corporation X assets. Corporation X will then be deemed to distribute the nominal share of

Corporation Y stock to J in addition to the $100 of cash actually distributed to J. Pursuant to §1.368-2(l), J, the actual shareholder of Corporation Y, the issuing corporation, is deemed to receive the nominal share of Corporation Y stock described in §1.368-2(l). J will have a basis of $50 in the nominal share of Corporation Y stock under section 358(a)(1). Therefore, under paragraph (a)(2)(iii)(B) of this section, J must designate a share of Corporation Y stock to which J's basis of $50 in the nominal share of Corporation Y stock will attach.

Example 16. (i) Facts. Each of Corporation X and Corporation Y has a single class of stock outstanding, all of which is owned by Corporation P. Corporation T has a single class of stock outstanding, all of which is owned by Corporation X. The corporations do not join in the filing of a consolidated return. Corporation X purchased 100 shares of Corporation T stock on Date 1 for $1.50 each, resulting in Corporation X having an aggregate basis in the stock of Corporation T of $150. On Date 2, Corporation Y acquires the assets of Corporation T for $100 of cash, their fair market value, in a transaction described in §1.368-2(l). Pursuant to the terms of the exchange, Corporation T does not receive any Corporation Y stock. Corporation T distributes the $100 of cash to Corporation X and retains no assets.

(ii) Analysis. Pursuant to § 1.368-2(l), Corporation Y will be deemed to issue a nominal share of Corporation Y stock to Corporation T in addition to the $100 of cash actually exchanged for the Corporation T assets. Corporation T will be deemed to distribute the nominal share of Corporation Y stock to Corporation X in addition to the $100 of cash actually distributed. Corporation X will have a basis of $50 in the nominal share of Corporation Y stock under section 358(a). However, Corporation X is not an actual shareholder of Corporation Y, the issuing corporation. Therefore, Corporation X cannot designate any share of Corporation Y stock under paragraph (a)(2)(iii)(B) of this section to which the basis of the nominal share of Corporation Y stock will attach and Corporation X will be deemed to distribute the nominal share of Corporation Y stock to Corporation P as required by §1.368-2(l). Corporation X does not recognize the loss on the deemed distribution of the nominal share to Corporation P under section 311(a). Corporation P's basis in the nominal share it receives is zero, its fair market value, under section 301(d). Under paragraph (a)(2)(iii)(B) of this section, Corporation P must designate a share of Corporation Y stock to which the nominal share's zero basis will attach.

Generally, since the IRS views these regulations as merely clarifying, rather than modifying, the older regulations, they apply to exchanges and distributions of stock and securities occurring after January 23, 2006.

However, due to the revisions of Examples 15 and 16, the revised versions will apply to exchanges and distributions of stock occurring after November 12, 2014. The temporary regulations versions of those examples will apply to transactions occurring on or after November 21, 2011 and before November 12, 2014.

Section: 381
Regulations Provide for Transfer of Earnings and Profits in Certain Corporate Tax Free Transactions

Citation: TD 9700, 11/10/14

In TD 9700, the IRS revised Regs. §1.312-11 and §1.381(a)-1 to clarify that, in general, if a corporation participates in a tax free exchange, distribution or other tax free transfers from one corporation to another as described in IRC §381(a), the corporation that acquires the assets of the transferor corporation will succeed to the transferor's earnings and profits, even if the receiving corporation ultimately retains none of the transferor's assets.

Transfers to which are described in IRC §381(a) are:

- A distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies; or

- A transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1),

The preamble notes that no allocation of earnings is to be made except in those cases where Reg. §1.312-10 applies (which deals with corporate separations).

These regulations are generally the same as the original proposed regulations with one clarifying change the IRS points to in the preamble. The IRS notes:

> The proposed section 312 regulations provided that "[e]xcept as provided in §1.312-10, in all other cases in which property is transferred from one corporation to another and no gain or loss is recognized (or is recognized only to the extent of the property received other than that permitted to be received without the recognition of gain), no allocation of the earnings and profits of the transferor is made to the transferee." These final regulations remove the language "and no gain or loss is recognized (or is recognized only to the extent of the property received other than that permitted to be received without the recognition of gain)." The IRS and the Treasury Department believe this language may inappropriately imply that allocation of earnings and profits may be permitted in cases in which gain not expressly described is recognized on the transfer of property between corporations (for example, gain required to be recognized under section 367 or 1001). This clarifying, non-substantive change confirms that except as provided in §1.312-10, in all other cases in which property is transferred from one corporation to another, no allocation of earnings and profits is made.

The final regulations apply to transaction occurring on or after November 10, 2014.

Section: 382
Application of Section 382 Ownership Change Rules to Initial Capitalization Transaction Explained

Citation: Chief Counsel Advice 201432015, 8/8/14

The IRS discussed initial capitalization issues and the loss trafficking limitation rules of IRC §382 in Chief Counsel Advice 201432015 (http://www.irs.gov/pub/irs-wd/201432015.pdf).

Generally, IRC §382 is meant to restrict the ability to "sell" a net operating loss by transferring ownership of a corporation with a net operating loss to outsiders. Absent §382, such individuals could buy a corporation that had incurred large losses and use that corporate shell as entity from which to start a new business or transfer in an existing one.

The memo outlines what events would trigger the application of IRC §382's limits:

> The pivotal event that triggers the operation of section 382 is an "ownership change," which occurs under section 382(g) whenever, immediately after (i) an owner shift involving a 5 percent shareholder or (ii) any equity structure shift, the percentage of stock of the loss corporation owned by one or more

> 5 percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period. Under section 382(k)(6)(A), preferred stock which is convertible into another class is considered stock for purposed of section 382. As provided in section 382(k)(6)(C), determinations of the percentage of stock held by any person is made on the basis of value. Under section 382(i), the testing period is generally the three-year period ending on the day of any owner shift involving a 5 percent shareholder or equity structure shift.

If such an ownership change is triggered, the amount of loss that can be used in the future is restricted based on the value of the loss corporation and a rate of return tied to the long term federal rate in effect when the ownership change occurs. Since 1995 that rate has never risen above 6% and recently has been in the low 3% range.

In the transaction in question a new corporation was being formed. During the period being looked at that gave rise to the inquiry to the National Office there were five separate issuances of stock. Just mechanically testing the five transactions, the fifth transaction would be treated as a §382 ownership change.

However the taxpayers have argued that the first three transactions were actually simply the original plan to provide initial capitalization of the entity. Thus, the organization argues, only the last two transactions are involved in the testing, with the owners at the end of the third transaction being treated as the original owner. Specially, if the third transaction is part of the initial issuance of stock and not itself a transfer of ownership, then the fifth transaction would no longer mechanically trigger an ownership change under §382.

The memorandum does not come to a conclusion about the validity of that position with the facts in question, but does hold that it is *possible* that the taxpayer's assertion with regard to the proper treatment is correct.

The memorandum notes:

> For example, assume stock of a start-up was issued on two different dates two months apart by a loss corporation where both issuances of stock were part of the initial capitalization of the loss corporation, and they both occurred before business activity had started. These facts do not present the abuse of trafficking in net operating loss carryovers, that section 382 was designed to prevent. Congress was concerned with situations where the shareholders who bore the economic burden of NOLs no longer hold a controlling interest in the corporation. H. Rept. 99-426, at 256 (1985), 1986-3 C.B. (Vol. 2) 1, 256. In this example, the shareholders who purchased stock on the two different dates were both the initial investors under the taxpayer's plan for the corporation's initial capitalization and both equally bore the economic burden of the NOLs arising after business activity commenced. The purpose of the statute would not have been served by treating the second acquisition as a testing date within the testing period of a subsequent testing date.

The analysis in the memorandum can be helpful in *planning* related to such original capitalization. For instance, getting all of the initial stock issued before business operations begins clearly is very useful in pushing all initial transactions outside the ownership shift testing period.

Section: 401
IRS Provides Rules to Allow Age-Based TDFs to be Offered as Benefit in Defined Contribution Plan

Citation: Notice 2014-66, 10/24/14

In Notice 2014-66, the IRS has provided rules under a defined contribution pension plan can offer as an investment option to plan participants a series of Target Date Funds (TDFs) that include deferred annuities where some of the TDFs are only available to older participants.

The problem arises due to the existence of nondiscrimination rules under IRC §401(a)(4) of the IRC that applies to such retirement plans. Benefits must be available to a nondiscriminatory group of employees. However, it is not actuarially feasible to offer such age-specific programs to employees outside the intended age range of a specific TDF.

Since older employees are often more likely to be highly compensated employees, there was concern that such programs could run afoul of the anti-discrimination provisions and put the plan's qualified status at risk.

The IRS provided that if such a program meets the following conditions it will not be found to be discriminatory with regard to §401(a)(4) regardless of the fact that some TDFs are available disproportionately to highly-compensated employees:

- The series of TDFs is designed to serve as a single integrated investment program under which the same investment manager manages each TDF and applies the same generally accepted investment theories across the series of TDFs. Thus, the only difference among the TDFs is the mix of assets selected by the investment manager, which difference results solely from the intent to achieve the level of risk appropriate for the age-band of individuals participating in each TDF. In accordance with the consistent investment strategy used to manage the series of TDFs, the design for the series is for the mix of assets in a TDF currently available for older participants to become available to each younger participant as the asset mix of each TDF for younger participants changes to reflect the increasing age of those participants.

- Some of the TDFs available to participants in older age-bands include deferred annuities, and none of the deferred annuities provide a guaranteed lifetime withdrawal benefit (GLWB) or guaranteed minimum withdrawal benefit (GMWB) feature.

- The TDFs do not hold employer securities, as described in section 407(d)(1)of the Employee Retirement Income Security Act of 1974, Public Law 93-406, as amended (ERISA), that are not readily tradable on an established securities market.

- Each TDF in the series is treated in the same manner with respect to rights or features other than the mix of assets. For example, the fees and administrative expenses for each TDF are determined in a consistent manner, and the extent to which those fees and expenses are paid from plan assets (rather than by the employer) is the same.

The IRS provided the following example of the type of arrangement meant to qualify under this ruling:

> Employer X sponsors Plan A, which is a profit-sharing plan qualified under § 401(a) that includes a qualified cash or deferred arrangement described in § 401(k). Participants in Plan A can commence distribution upon attainment of age 65, the normal retirement age under Plan A, or upon severance

from employment. Plan A provides participants the opportunity daily to direct the investment of assets held in, or contributed to, their accounts in a broad array of investment alternatives.

The designated investment alternatives available to all participants under Plan A include a series of TDFs managed by an investment manager (as defined in section 3(38) of ERISA) who acknowledges in writing that the investment manager is a fiduciary with respect to the plan. The TDFs are designed to provide varying degrees of long- term appreciation and capital preservation through a mix of equity and fixed-income exposures based on generally accepted investment theories. The same investment manager manages all the TDFs under Plan A, and makes asset allocation decisions using a consistent investment strategy under which the asset mix is designed to change over time, becoming more conservative through a gradual reduction in the allocation to equity investments and a gradual increase in the allocation to fixed-income exposure as the participants in each TDF grow older. None of the TDFs holds or permits the acquisition of employer securities.

Each TDF is available only to participants who will attain normal retirement age within a limited number of years around the target date for the fund. For example, investment in the 2020 TDF is restricted to participants who will attain normal retirement age in 2019, 2020 or 2021.

Each TDF is intended to be a qualified default investment alternative (QDIA) within the meaning of § 2550.404c-5(e) of the Department of Labor regulations, which describes the attributes necessary for an investment fund, product, model portfolio, or managed account to be a QDIA.2 The plan sponsor also represents that it will satisfy the conditions of § 2550.404c-5(c) of the QDIA regulation, including the requirement that participants be furnished a notice of the circumstances under which their assets may be invested in the QDIA, their right to direct the investment of their assets into any other plan investment alternatives, and the investment objectives, risk and return characteristics, and fees and expenses attendant to the QDIA.

Each TDF available to participants age 55 or older holds unallocated deferred annuity contracts as a portion of its fixed-income exposure. The deferred annuity contracts are purchased from an insurance company that is independent from the investment manager. None of the TDFs provides a GLWB or GMWB feature.

As the age of the group of participants in such a TDF increases, a larger portion of the assets in the TDF will be used to purchase deferred annuities each year. The TDFs available to participants younger than age 55 do not include deferred annuity contracts. However, the series of TDFs is designed so that, as the asset allocation changes over time, each TDF will include deferred annuity contracts beginning when the participants in that TDF attain age 55.

Each TDF is dissolved at its target date. When a TDF is dissolved, a participant who has an interest in that TDF will receive an annuity certificate representing the participant's interest in the annuity contract held in the TDF. The certificate provides for immediate or deferred commencement of annuity payments in accordance with the terms of the annuity contract and the plan. The remaining portion of a participant's interest in that TDF is reinvested in other investment options within Plan A.

The investment manager and Employer X treat each TDF in the series in the same manner with respect to rights or features other than the mix of assets. For example, with respect to each TDF, the investment manager determines the fees and administrative expenses in a consistent manner, and the percentage of those fees and expenses that are paid from plan assets (rather than by Employer X) is the same.

> Pursuant to the alternative method of compliance with the nondiscrimination requirements of § 401(a)(4) under section III of this notice, the series of TDFs in this example is treated as a single other right or feature for purposes of § 1.401(a)(4)-4. Therefore, each of the TDFs will satisfy the nondiscrimination requirements of § 1.401(a)(4)-4.

Section: 401
Participants in Defined Contribution Plans to Be Allowed to Use a Portion of Benefits to Purchase Qualifed Longevity Annuity Contract

Citation: TD 9673, 7/1/14

The IRS revised regulations in TD 9673 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-15524.pdf) governing minimum required distributions from defined contribution plans and IRAs to allow, within limits, a plan to allow a participant to direct a portion of his/her benefit to purchase a longevity annuity. If an employee directs a portion of his account to purchase an annuity to purchase an annuity that will begin a lifetime payout no later than age 85, the value of the annuity and premium paid will not be otherwise included in computing the employee's required minimum distribution each year from the plan.

The maximum balance that can be used to purchase this annuity is limited to no more than 25% of the employees account balance or $125,000 on the date of payment, whichever is less. The maximum dollar limitation will be adjusted in future years in a similar manner as the dollar limit under IRC §415(d) (the annual dollar cap on allocations to a participant's account). However it would only move in $10,000 increments.

A participant taking advantage of this provision is effectively "banking" a portion of the account to provide for an increased benefit when he/she is older. The annuity will also allow a longer deferral of income, thought with the trade-off of requiring these funds to be held in an annuity contract as opposed to being fully invested as the participant sees fit.

Section: 401
IRS Issues Guidance Providing Plan Guidance and Relief on Retroactive Effect of Windsor Decision

Citation: Notice 2014-19, 4/4/14

Invoking its authority under IRC §7805(b), the IRS in Notice 2014-19, http://www.irs.gov/pub/irs-drop/n-14-19.pdf, provided guidance to qualified retirement plans regarding the application of the Supreme Court's decision in the case of *United States v. Windsor*, S. Ct. 2675 (2013).

The *Windsor* case dealt with Congress's ability (or lack thereof as the decision held) to ignore state law marriages for purposes of federal law unless they involved a man and a woman. The Supreme Court decided the Congress lacked that authority and, thus, such marriages had to be recognized for federal tax purposes.

This creates problems for qualified retirement plans, since the IRS notes that the following areas are impacted in the qualified plan area by the existence of a marital relationship:

> Several Code sections provide special rules with respect to married participants in qualified retirement plans, including, but not limited to, the following: • Under section 401(a)(11), certain qualified retirement plans must provide a qualified joint and survivor annuity (QJSA) upon retirement to married participants (and generally must provide a qualified preretirement survivor annuity (QPSA)

to the surviving spouse of a married participant who dies before retirement). If a plan is subject to these rules, the QJSA (or QPSA) may be waived by a married participant only with spousal consent pursuant to section 417. If such a plan permits loans to participants, then section 417(a)(4) requires a plan to obtain the consent of the spouse of a married participant before making a loan to the participant. • Under section 401(a)(11)(B)(iii), certain qualified defined contribution retirement plans are exempt from the QJSA and QPSA requirements provided that a married participant's benefit is payable in full, on the death of the participant, to the participant's surviving spouse, unless the surviving spouse consents to the designation of a different beneficiary. • Under the required minimum distribution rules of section 401(a)(9) and the rollover rules of section 402(c), additional alternatives are provided for surviving spouses that are not available to non-spousal beneficiaries. • Under section 1563(e)(5), generally a spouse is treated as owning shares owned by the other spouse for purposes of determining whether corporations are members of a controlled group under section 414(b). • Under section 318(a)(1), generally a spouse is treated as owning shares owned by the other spouse for purposes of determining whether an employee is a key employee under section 416(i)(1), including whether an employee is considered a 5% owner. • Under section 409(n), an employee stock ownership plan (ESOP) that acquires certain employer securities generally must prohibit the allocation or accrual of those securities for the benefit of certain individuals, including the spouse of the seller and the spouse of any individual who owns 25% or more of the securities. • Under section 409(p), no portion of the assets of an ESOP attributable to employer securities consisting of S corporation stock may accrue during a nonallocation year for the benefit of any disqualified person or certain family members of the disqualified person (including the spouse) in certain circumstances. • Under section 401(a)(13)(B), the anti-alienation rules do not apply to the creation, assignment, or recognition of an alternate payee's right to receive all or a portion of the benefits payable to a participant under a plan pursuant to a qualified domestic relations order (QDRO) described in section 414(p), and, under section 402(e)(1), an alternate payee who is a spouse or former spouse of the participant is treated as the distributee of a distribution under a QDRO.

Since Congress, in the Court's view *never* had the authority to have such marriages ignored under federal law, such marriages have always been valid. And, taken to the logical next step, plans that had not treated such marriages as valid (which would be virtually every plan in existence) could easily have violated a number of the above provisions and, as well, might face significant liabilities to, say, surviving same sex spouses who had not signed a release of rights to a joint annuity.

However, IRC §7805(b)(8) grants the IRS the right to limit the retroactive affect of, among other things, any judicial holding.

The notice is issued in question and answer format, and deals with a number of issues.

First, the notice holds that the plan must apply the *Windsor* decision (and thus recognize same sex marriages) as of June 26, 2013, the date the decision was issued. However a plan is not required, if it did not recognize such marriages prior to that date, to recognize the marriages before that date.

The notice grants that a plan may elect to apply some or all of the *Windsor* decision prior to that date via an amendment to the plan, though the IRS warns plans that applying some aspects of the *Windsor* decision retroactive may prove very difficult to do or create side effects that must be carefully considered before taking this step. For instance, a plan fully complying with *Windsor* retroactively would need to apply such rules for purposes of ownership attribution--and that could create a number of problems for the plan, especially if a major owner is in a same sex marriage with a partner who also is a business owner.

As well, the notice points out that a plan may need to be amended to comply with the results of *Windsor* and the holdings of prior Rev. Rul. 2013-17. That ruling, issued shortly after the Windsor decision, held:

> (1) For Federal tax purposes, the terms " spouse," " husband and wife," " husband," and " wife" include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term " marriage" includes such a marriage between individuals of the same sex.
>
> (2) For Federal tax purposes, the Internal Revenue Service (Service) adopts a general rule recognizing a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages.
>
> (3) For Federal tax purposes, the terms " spouse," " husband and wife," " husband," and " wife" do not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state, and the term " marriage" does not include such formal relationships.

If a plan's language has a definition of marriage for any purpose that does not conform with the above treatment, it will need to be amended.

Any such amendments must be made by the later of:

- The end of the first plan year for which the change is effective;
- Due date of the employer's tax return for the tax year that includes the year when the change is first effective; [Rev. Proc. 2007-44] or
- December 31, 2014 [special rule under this Notice]

The IRS also ruled that any amendment is not subject to the rules of IRC §436(c) that limits changes to single-employer defined benefit plans that increase the plan's liabilities based on the plan's adjusted funding target attainment percentage.

Section: 401
Temporary Relief Granted for Nondiscrimination Testing for Closed Defined Benefit Plans, IRS Seeks Comments on a Permanent Solution

Citation: Notice 2014-5, 12/13/13

In recent years a number of employers have decided to switch from offering a defined benefit pension (DB) plan to offering a defined contribution (DC) plan. In some cases the employers decided to do so by closing the defined benefit plan to employees hired after a certain date (a "closed" plan), but continuing to accrue benefits to employees already in the defined benefit plan. Notice 2014-5 (http://www.irs.gov/pub/n-14-05.pdf) was issued to deal with a particular issue that arises in this context.

Generally qualified plans must demonstrate they do no discriminate in favor of highly compensated employees (HCEs) as compared to non-highly compensated employees (NHCEs). When a closed defined benefit plan is involved, the combination of the DB and DC plans is tested for improper discrimination pursuant to options offered under Reg. §1.401(a)(9)-9(a).

In many cases the concentration of HCEs in the closed DB plan will increase over time and may make it difficult for the combined plans to meet the discrimination testing. In such a case the notice comments that an employer will face three potential solutions:

- Reduce the proportion of HCEs in the closed DB plan (by either opening it to some new NHCEs or by stopping participation by some HCEs);
- Reconfigure the contributions under the DC plan so that it meets the minimum aggregate allocation gateway; or
- Cease accruals in the DB plan entirely.

The first option has the obvious negative of either putting new employees in the DB plan (something closing it was meant to stop) or kicking out some of the employees whose benefits the employer sought to protect. The second option may be deemed to be prohibitively expensive by the employer, especially since the employer may already be making a substantial contribution but not under a method that will count towards the minimum allocation gateway (such as matching contributions).

Thus that leaves only option 3—effectively shutting down the DB plan for the old employees. Since the IRS considers this a "suboptimal" solution, the notice seeks to offer temporary relief as the IRS searches for a more permanent solution.

The IRS rejected the suggestion of allowing a DB plan that is once able to demonstrate nondiscrimination requirements at the time the plan was closed or at a later date to be treated as permanently nondiscriminatory. The IRS was concerned that such a rule would apply a lower standard to closed DB plans than active DB plans, encouraging the closing of such plans.

So the IRS has decided instead to create a temporary relief provision for plan years beginning before January 1, 2016 for a DB plan that was amended prior to December 31, 2013 to close the plan if each DB plan in the combined DB/DC plans meets one of the following conditions:

> 1. For the plan year beginning in 2013, the DB plan was part of a DB/DC plan that either was primarily defined benefit in character (within the meaning of § 1.401(a)(4)-9(b)(2)(v)(B)) or consisted of broadly available separate plans (within the meaning of § 1.401(a)(4)-9(b)(2)(v)(C)), or
>
> 2. In the case of a DB plan that was amended, by an amendment adopted before December 13, 2013, to provide that only employees who participated in the DB plan on a specified date continue to accrue benefits under the plan, the DB plan was not part of a DB/DC plan for the plan year beginning in 2013 because the DB plan satisfied the coverage and nondiscrimination requirements without aggregation with any DC plan.

During this temporary relief periods the plans must continue to meet all of the other nondiscrimination provisions of IRC §401(a)(4).

The IRS goes on to describe some potential future relief options that it might adopt as a permanent solution and requests comments on solving this problem in a more permanent manner.

Section: 401
Final Regulations Allow Method for Employer to Stop Safe Harbor Contributions to Plans and Revert to Testing Mid-Year

Citation: TD 9641, 11/15/13

The IRS has issued final regulations that outline the situations under which an employer who has a safe harbor §401(k) arrangement may reduce a non-elective contribution. The revisions to Reg. §1.401(k)-3 are found at http://www.gpo.gov/fdsys/pkg/FR-2013-11-15/pdf/2013-27452.pdf.

Normally a §401(k) plan is tested using the average deferral percentage (ADP) test or the actual contribution percentage (ACP) test which serves to limit the deferrals of the highly compensated employees. To avoid that testing and limitation, a safe harbor plan may be adopted that provides for either a non-elective contribution of 3% of compensation for all eligible non-highly compensated individuals or various specified matching contributions.

These regulations provide for an option for employers who want to reduce the non-elective contribution. Under the final regulations an employer may reduce the contribution either if the employer is operating at an economic loss (as described in §412(c)(2)(A)) or, if the employer provides notice before the year begins that it reserves the right to reduce the non-elective contribution. The reduction cannot take effect until 30 days after the notice is given.

The regulations also modify the already existing rules to allow for a reduction in matching contributions to insure the rules for non-matching contributions are not stricter than those for a reduction in safe harbor matching contributions.

Thus similar rules are provided for a reduction in matching contributions. Because these rules represent a change in such provisions, the change in matching contributions will not take effective until plan years beginning in 2015.

Section: 401
Department of Labor Decides State of Celebration Determines Validity of Participants' Marriages

Citation: EBSA Technical Release 2013-04, 9/18/13

The Employee Benefits Security Administration of the Department of Labor issued guidance in Technical Release 2013-04 (http://www.dol.gov/ebsa/pdf/tr13-04.pdf) that, for purposes of employee benefit plans, individuals who were treated as legally married under any state law will be treated as married regardless of the status of that marriage in their current state of residence. The Department has adopted what is generally referred to as the "state of celebration" test for a marriage.

This guidance was issued in response to the U.S. Supreme Court's *Windsor* decision and is generally consistent with the IRS' prior guidance in Revenue Ruling 2013-17.

The Department justified its position by noting:

> A rule that recognizes marriages that are valid in the state in which they were celebrated, regardless of the married couple's state of domicile, provides a uniform rule of recognition that can be applied with certainty by stakeholders, including employers, plan administrators, participants, and beneficiaries.

The Technical Release notes the problems with the alternative "state of residency" test for plan administration:

> A rule for employee benefit plans based on state of domicile would raise significant challenges for employers that operate or have employees(or former employees) in more than one state or whose employees move to another state while entitled to benefits. Furthermore, substantial financial and administrative burdens would be placed on those employers, as well as the administrators of employee benefit plans. For example, the need for and validity of spousal elections, consents, and notices could change each time an employee, former employee, or spouse moved to a state with different marriage recognition rules. To administer employee benefit plans, employers (or plan

> administrators) would need to inquire whether each employee receiving plan benefits was married and, if so, whether the employee's spouse was the same sex or opposite sex from the employee. In addition, the employers or plan administrators would need to continually track the state of domicile of all same-sex married employees and former employees and their spouses. For all of these reasons, plan administration would grow increasingly complex, administrators of employee benefit plans would have to be retrained, and systems reworked, to comply with an unprecedented and complex system that divides married employees according to their sexual orientation. In many cases, the tracking of employee and spouse domiciles would be less than perfectly accurate or timely and would result in errors or delays.

The notice also provides that the Department expects to continue to issue guidance dealing with other employee benefit issues raised by the *Windsor* decision.

Section: 402
Revised Safe Harbor Rollover Distribution Notices Issued by the IRS to Take Into Account Changes to In-Plan Roth Rollovers and New Pre- and Post-Tax Contributions Rules

Citation: Notice 2014-74, 11/24/14

The IRS has updated the safe harbor notices to be provided to qualified plan participants who receive rollover distributions in Notice 2014-74. The changes are made to incorporate additional details about in-plan Roth rollovers and the revisions to the allocation of pretax and after-tax amounts found in Notice 2014-54.

The use of the safe harbor notices by the plan can satisfy the requirements of IRC §402(f) to provide information to recipients of such distributions. The revisions update the notices for changes in the law since the last version of the notices was issued (Notice 2009-68 on September 28, 2009).

The notice describes the changes made to the model notices and also provides full copies of the revised notices.

The notice indicates that the instructions on the use of such notices found in Notice 2009-68 continue to apply. Those instructions provide:

> A plan administrator or payor may customize a safe harbor explanation by omitting any information that does not apply to the plan. For example, if the plan does not hold after-tax employee contributions, it would be appropriate for the section "If your payment includes after-tax contributions" in the explanation for payments not from a designated Roth account to be eliminated. Similarly, if the plan does not provide for distributions of employer stock or other employer securities, it would be appropriate for the section "If your payment includes employer stock that you do not roll over" to be eliminated. Other information that may not be relevant to a particular plan includes, for example, the sections "If your payment is from a governmental section 457(b) plan," and "If you are an eligible retired public safety officer and your pension payment is used to pay for health coverage or qualified long-term care insurance." In addition, the plan administrator or payor may provide additional information with a safe harbor explanation if the information is not inconsistent with § 402(f).
>
> Alternatively, a plan administrator or payor can satisfy § 402(f) by providing an explanation that is different from a safe harbor explanation. Any explanation must contain the information required by § 402(f) and must be written in a manner designed to be easily understood.

The notice cautions that these safe harbor explanations will not automatically satisfy the requirements of §402(f) to the extent they are inconsistent with any changes in the law occurring after December 8, 2014—

thus plan administrators will need to modify the documents to take into account any changes that occur after that date.

Advisers working with qualified plans should be sure to download the revised notices and incorporate them into the documents used by the plans they are associated with.

Section: 402A
Guidance Issued on In-Plan Roth Rollovers Following ATRA Changes

Citation: Notice 2013-74, 12/11/13

The IRS released Notice 2013-74 (http://www.irs.gov/pub/irs-drop/n-13-74.pdf) giving guidance to plan sponsors on implementing the new in-plan rollover provisions allowable for Roth accounts in retirement plans that was added in the American Taxpayer Relief Act of 2012 (ATRA).

The Notice clarifies the modifications effective to the guidance in Notice 2010-84 which applied to the pre-ATRA Roth rollover provisions. The notice indicates that generally the provisions of Notice 2010-84 will apply, but that certain provisions no longer are applicable:

> However, as a result of the expansion of eligibility for in-plan Roth rollovers made by ATRA, the part of Q&A-2 of Notice 2010-84 that provides that an amount is not eligible for an in-plan Roth rollover unless it satisfies the rules for distribution under the Code no longer applies. In addition, the following parts of Notice 2010-84 apply only to an in-plan Roth rollover of an otherwise distributable amount and do not apply to an in-plan Roth rollover of an otherwise nondistributable amount: (i) the part of Q&A-1 that provides that an in-plan Roth rollover may be accomplished by an in-plan Roth 60-day rollover; and (ii) Q&A-5, relating to the requirement for a revised § 402(f) notice. Thus, a § 402(f) notice is not required for a participant making an in-plan Roth rollover of an otherwise nondistributable amount.

Under the ATRA provisions, the following amounts may be rolled over to a designated Roth account in the same plan:

- Elective deferrals in § 401(k) plans and § 403(b) plans (The federal government's Thrift Savings Plan is treated as a § 401(k) plan for this purpose.)
- Matching contributions and nonelective contributions, including qualified matching contributions and qualified nonelective contributions described in § 1.401(k)-6
- Annual deferrals made to governmental § 457(b) plans.

The notice provides that the rollovers are not subject to federal income tax withholding and, to the extent the distributions are those authorized by ATRA for amounts not otherwise eligible for current distributions, voluntary withholding is also not available. The latter is due to the fact that the only authorized transfer of such funds is directly to a designated Roth account, and thus no funds may be diverted to federal withholding.

The notice also sets forth special deadlines and rules for amending plans to allow for 2013 rollovers.

- For §401(k) plans, a plan may allow for 2013 in-plan Roth rollovers so long as the plan adopts the enabling amendment retroactively allowing such rollovers by December 31, 2014
- §401(k) safe harbor plans are granted temporary relief from the prohibition on mid-year plan changes to enable in-plan Roth rollovers for 2013 and 2014 so long as they adopt the relevant plan amendment by December 31, 2014

- §403(b) plans that are subject to the "remedial amendment period" rules of Revenue Procedure 2013-22 may adopt "a plan amendment permitting in-plan Roth rollovers of otherwise nondistributable amounts is permitted to be adopted on or before the last day of that remedial amendment period or, if later, the last day of the first plan year in which the amendment is effective, provided the amendment is effective as of the date the plan first operates in accordance with the amendment."
- Governmental §457 plans that wish to allow in-plan Roth rollovers in 2013 or 2014 must amend their plan on or before December 31, 2014

In addition to permitting in-plan Roth rollovers, the notice provides the plan(s) may adopt any of the other related amendments at the same time (with the same retroactive effect)

- A plan amendment that permits elective deferrals under the plan to be designated as Roth contributions
- A plan amendment that provides for the acceptance of rollover contributions by designated Roth accounts
- A plan amendment that permits in-plan Roth rollovers of some or all otherwise distributable amounts.

The notice also provides that the plan may place limits on the type and frequency of Roth rollovers allowed by the plan (so long as not done in a discriminatory fashion). As well, the notice clarified that the ability to make an in-plan Roth rollover is not a protected benefit under §411(d)(6).

This would allow a plan to remove the ability to make such rollovers, though that removal would be subject to the provisions found in IRC §1.401(a)(4)-5 that would test such an amendment to see if it had the effect of discriminating in favor of the highly compensated employees. The latter warning suggests that an employer would like be operating outside the rules if the employer put an in-plan rollover provision in the plan for an extremely short period during which the owners quickly moved their funds into the Roth account, and then removed the option to avoid having to account for such accounts for other participants.

An in-plan Roth rollover that is the employee's first contribution to the employee's Roth IRA account, the 5 year period begins on the first day of the first taxable year during which the in-plan rollover is made.

The notice also contains additional guidance on the effect of the rollover on the net unrealized appreciation (NUA) provisions, top-heavy status issues and treatment of excess contributions.

Section: 404
Plan Language Saves Possible Loss of Six Figure Deductions to Fund Defined Benefit Plan

Citation: Peterson v. Commissioner, TC Memo 2013-271, 11/26/13

A taxpayer's defined benefit pension plan funding deduction was saved by what might be viewed as fluke of sorts in the case of Peterson v. Commissioner, TC Memo 2013-271, http://www.ustaxcourt.gov/InOpHistoric/Peterson_Foley.TCM.WPD.pdf.

The taxpayer had been a Mary Kay consultant—and a successful one. She formed a defined benefit pension plan that was adopted by her proprietorship.

Later she and her husband attempted to transfer the Mary Kay income to a limited partnership they formed. The Court doesn't go into the reasoning for forming this partnership, but it turned out that Mary Kay would not agree to pay the income to the partnership.

However, the Petersons began reporting the expenses of the Mary Kay business and the income on the partnership. The defined benefit plan was also restated and adopted by the partnership. The partnership claimed deductions for funding the plan of $275,365, $312,266, and $173,500 for the years in question along with all other income and expenses related to the Mary Kay business. This income flowed onto the Petersons' returns via the K-1s.

The parties now agreed that the partnership was not truly in business. The IRS argued that because of this, there was no income on which a plan contribution could be based given the plan was the partnership's plan and the partnership generated no self-employment income on which to base the contribution.

The Tax Court noted that Ms. Peterson was in business, a point conceded by the IRS. The Court also pointed out that the restated plan document adopted when the partnership was formed provided that the "employer" sponsoring the plan was "the entity specified in the Adoption Agreement, any successor which shall maintain this Plan and any predecessor which has maintained this Plan."

Ms. Peterson's sole proprietorship was the original plan sponsor, thus qualified as a predecessor of the current sponsor. Thus, by the terms of the plan, her proprietorship was an employer for plan purposes and it could thus contribute to the plan and claim a deduction.

Note that had the plan not been adopted until after the partnership was formed, the Court would not have had access to this ability to "save" the plan contributions. In such a case, the taxpayer's unsuccessful attempt to "assign" its operations to an entity not recognized by the other contracting entity would apparently have resulted in a total disallowance of the very significant deductions.

Section: 408A
Treasury to Administer Pilot "myRA" Retirement Savings Program

Citation: White House Fact Sheet, "Opportunity for All: Securing a Dignified Retirement for All Americans", 1/29/14

In the State of the Union address, the President announced a "new" retirement program (myRA), additional details of which were released in a fact sheet the following day (http://www.whitehouse.gov/the-press-office/2014/01/28/fact-sheet-opportunity-all-securing-dignified-retirement-all-americans). That fact sheet was later supplemented by a slightly more detailed fact sheet from the Department of Treasury (http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf). The speech contained a mix of items that can be currently enacted via executive action of the President, and proposed additional options that would require Congressional action.

For tax advisers the key question boils down to simply what is this thing? How is it classified under the Internal Revenue Code? And what should we tell clients who ask about the program?

The program is being created under an existing authority of the Treasury to allow employees of private companies to purchase U.S. Savings Bonds via payroll deduction. While the details aren't totally clear at this point, it appears that the Treasury will hold these bonds in an account that will, under the IRC, function as a Roth IRA. Thus all of the standard provisions application to Roth IRAs should apply to these accounts, with certain addition limitations imposed by the Treasury acting as custodian.

The program will initially be offered to employees of employers that choose to participate by the end of 2014. The accounts will be funded via payroll deductions. The minimum initial contribution will be $25, with additional contributions of $5 or more. The maximum that can put into such an account will be $15,000, at which point the participant will need to roll the account over to a standard Roth IRA. The fact sheet indicates a similar limit of 30 years in the program at which time presumably the holder would also need to roll to a Roth IRA.

The accounts will earn a return that is the same as the variable interest rate paid to federal employees participating in the Thrift Savings Program. Being invested in U.S. Bonds, the principal will be insured against loss.

To be eligible for the program a household could have income of "up to $191,000" a year, which just happens to be the point at which eligibility for a Roth IRA contribution stops for a married couple filing a joint return for 2014 (Notice 2013-73). The same limits as apply otherwise for Roth IRA contributions would appear to apply to this program and, presumably, excess contributions will subject to the same excess contributions tax as other Roth accounts.

The Treasury fact sheet more clearly ties the limits to the Roth IRA limitations, specifically indicating that the accounts are Roth IRA accounts and that the standard Roth limits based on filing status apply. The fact also makes clear the program will only be available via a payroll deduction through participating employers.

While the President discussed options of allowing employer to automatically enroll employees in the program where they would have to "opt out" if they did not want to save and requiring all employers to offer a savings option if employees did not already have such an option, those items would require additional Congressional action.

Absent Congressional action, the program will only impact employers who elect to participate in the program and then any of their employees who elect to make a deferral into the program. Employers who decide they might want to participate in the program will need to be aware of rules (presumably to come) regarding how the funds are to be transferred and the deadlines for making such a transfer.

Section: 415
IRS Announces 2015 Qualified Plan Inflation Adjusted Limits

Citation: IRS News Release IR-2014-99, 10/23/14

The IRS announced in News Release IR-2014-99 the inflation adjusted limitations imposed on qualified plans for 2015. Key items that have changed include the annual elective deferrals under 401(k) and similar plans (up to $18,000 from $17,500) and the catch-up contribution amounts for such plans (up to $6,000 from $5,500).

Type	2015 Amounts	2014 Amounts
Maximum annual benefit-DB Plan (§415)	$ 210,000	$ 210,000
Contribution limit DC Plan (§415)	53,000	52,000
Annual Compensation Limit (§404(l))	265,000	260,000
Catch up Contributions to Employer Plan	6,000	5,500
Elective Deferrals (§402(g))	18,000	17,500

Highly Compensated Employee (§414(q))	120,000	115,000
Key Employee Compensation (§416(i))	170,000	170,000
SIMPLE Deferral Limitation (§408(p))	12,500	12,000
SIMPLE Catch Up Contribution (414(v)(2)(B))	3,000	2,500
SEP Compensation Limit (§408(k))	600	550
Roth IRA Maximum Contribution Phaseout Begins:		
Married filing joint	183,000	181,000
Other except married filing separate	116,000	114,000

Section: 446
Subsidiary that Converted to Disregarded Entity SMLLC May Nevertheless Have a Distinct Trade or Business from Parent for Electing Accounting Methods

Citation: CCA 201430013, 7/25/14

In Chief Counsel Advice 201430013 (http://www.irs.gov/pub/irs-wd/201430013.pdf) the IRS the fact that a single taxable entity may have separate and distinct trades or businesses.

In the issue that lead to the memorandum, the taxpayer had a subsidiary that converted to a single member LLC. The SMLLC did not elect to be treated as a corporation and thus the entity is now treated as an entity disregarded as apart from its parent. The parent and the SMLLC keep separate books and records.

However, since the SMLLC has now, for tax purposes, liquidated itself and been subsumed into the parent, the issue is whether the entity must now use the same accounting method as its parent.

The answer is not necessarily. As the memo notes, IRC §446(d) provides:

> A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

Reg. §1.446-1(d) provides the tests to determine separate trades or businesses and provides:

> (d) Taxpayer engaged in more than one business.
>
> (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

In the particular facts in the memo the National Office made clear the mere fact that the SMLLC did not "check the box" did not mean there were not separate trades or businesses. In fact, in the particular facts in question the memorandum concluded that this entity did appear to have two separate trades or businesses and could make separate accounting method choices despite being a single tax entity.

Section: 446
Taxpayer Switching From Deducting Expense Twice to Properly Deducting an Expense Once Is Not Changing Its Accounting Method

Citation: CCA 201345025, 11/15/13

In CCA 201345025 (http://www.irs.gov/pub/irs-wd/1345025.pdf) it is explained that an item is treated as an accounting method by using a test referred to as the "lifetime income" test. Effectively, to be an accounting method issue, the new and old treatments must result on in difference of timing, where lifetime income for the enterprise would be the same.

In the case in question the taxpayer had been deducting commissions twice, once when the employee earned the commission and once when the commission is paid. The question was whether the taxpayer had a change in accounting method if the taxpayer now begins to deduct the commission only once.

The memorandum concludes that because switching from a double deduction to a single deduction changes lifetime income, the change is not a change in accounting method.

Section: 451
Sales of Gift Cards Redeemable by Unrelated Third Parties Now Qualify for Deferral Method of Revenue Procedure 2004-34

Citation: Rev. Proc. 2013-29, 7/24/13

In Revenue Procedure 2013-29 (http://www.irs.gov/pub/irs-drop/rp-13-29.pdf) the IRS expanded the ability to defer amounts received from the sale of gift cards beyond that originally allowed in Revenue Procedure 2011-18. Both procedures talk about qualifying the sale of gift cards for the deferral method of revenue recognition described in Revenue Procedure 2004-34

For transactions that qualify to come under the purview of Revenue Procedure 2004-34, a taxpayer does not need to recognize income from such advance payments in the year of receipt to the extent it is not recognized in the taxpayer's "applicable financial statement" or, if a taxpayer doesn't have an applicable financial statement, to the extent earned in the year of receipt. The balance will be recognized for tax purposes in the following year regardless of whether or not it continues to be deferred under the taxpayer's method of accounting.

The previous rules did not allow a taxpayer who sold a gift card that was redeemed by an unrelated entity from using this method, since only the redeeming entity recognizes income upon the sale of the goods or services. The revisions allows the selling entity to "piggyback" on the sale by the redeeming entity and treat the income earned at that point. Thus the taxpayer can use the deferral method of Revenue Procedure 2004-34 for such sales.

The ruling also gives retroactive effect to the provision, thus offering audit protection for entities that may have been using this method for cards redeemed by unrelated entities.

If an entity has not been using this method to report income, advisers must comply with the change of accounting method provisions found in Revenue Procedure 2004-34.

Section: 460
Taxpayer Who Developed Residential Land But Did Not Construct Homes Was Not a Homebuilder and Could Not Use Completed Contract Method

Citation: The Howard Hughes Company, LLC v. Commissioner, 142 TC No. 20,

In the case of *The Howard Hughes Company, LLC v. Commissioner*, 142 TC No. 20, http://www.ustaxcourt.gov/InOpHistoric/HowardHughesDiv.Wherry.TC.WPD.pdf, the Tax Court clarified the limit of its decision in *Shea Homes, Inc. v. Commissioner, 142 TC No.3*.

As you may recall, in the *Shea Homes* case the Tax Court decided that a developer could include the allocable portion of the costs of common area improvements in determining costs of home construction for purposes of meeting the 95% test for a completed contract. The IRS argued, unsuccessfully, that once *Shea Homes* had incurred over 95 of the costs of constructing the home on the lot it had to treat that home contract as completed regardless of the status of common area improvements.

The *Hughes* case involved a taxpayer that argued that, not only was the building and completion of the structure not the only issue, but that they should qualify as a homebuilder and be able to use the completed contract method even though this developer merely readied land and then sold it off to homebuilders or individuals who, presumably planned to build homes on the lots (though it turned out some were unable to actually do so).

There does appear to be a certain elegance to the argument given that the Tax Court decided general common area improvements were costs of constructing the homes—but the Court found that to lump it with the basic home construction, the taxpayer had to actually be involved in constructing homes to which the costs could be attached.

IRC §460(e)(6) defines a home construction contract as follows:

> (A) Home construction contract.--The term “home construction contract” means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to--
>
> > (i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and
> >
> > (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.

Hughes argued that their costs were “directly related” to dwelling units.

While agreeing that “the structures to be ultimately built upon the land petitioners sell in the contracts at issue are dwelling units” the Court however noted:

> Importantly, however, petitioners did not build homes on the land they sold, nor did qualifying dwelling units exist on the sold land at the time of the sales. Petitioners have not established that at the time of each sale qualifying dwelling units would ever be built on the sold land.

In fact, the Court noted that in the case of one sale the buyer defaulted and years later no homes had yet been built.

> As far as we know, no qualifying dwelling units will ever be built on these lands, and deferral of income from contracts that might not ever result in qualifying dwelling units seem entirely inappropriate under these circumstances.

A key difference from the *Shea* case was that:

> In *Shea Homes*, the taxpayers closed their contracts only after a certificate of occupancy had been issued and simultaneously with the purchaser's taking possession of their house.

More particularly, the Court held:

> If the taxpayer does not construct or intend to construct qualified dwelling units, there is no allocable share of common improvement costs. . . . Petitioners were not homebuilders, and their contracts were not home construction contracts.

Section: 460
Residential Developer Allowed to Consider Common Area Amenities in Determining Completion of Individual Contracts of Sale for Residences Under Completed Contract Method

Citation: Shea Homes, Inc. v. Commissioner, 142 TC No.3, 2/12/14

In the case of *Shea Homes, Inc. v. Commissioner*, 142 TC No.3, http://www.ustaxcourt.gov/InOpHistoric/SheaHomesDiv.Wherry.TC.WPD.pdf, the question of the scope of contracts of a homebuilder when making use of the completed contract method was the key issue.

The taxpayer developed large planned residential communities which had substantial common area developments and improvements required by the localities in which the developments were located.

While most long term contracts must be accounted for using the percentage of completion method [IRC §460(a)]. However, a special exception exists for home construction contracts [IRC§460(e)(1)(A), (6)(A)]. A home construction contract is one in which 80% or more of the estimated total contract costs are expected to be attributable to dwelling units and improvements to real property directly related to such units.

Under the completed contract method, revenue from the contract is recognized when either of two "completion" tests are met [Reg. §1.460-1(f)]:

- Use and 95% Completion Test – completion takes place upon use of the property by the customer for its intended purpose and at least 95% of the total allocable costs attributable to the subject matter have been incurred by the taxpayer; *or*
- Final Completion and Acceptance Test – completion takes place upon final completion and acceptance by the customer, determined by taking into account all facts and circumstances.

The dispute arose over what consideration, if any, should be given to costs related to development wide expenses (common areas, road improvements, etc.) and their state of completion when making the determination under either of the above tests.

The IRS argued that when a customer closes on the home after the construction of their structure is completed that both tests are met, and the entire contract price for that home should be recognized by the taxpayer. In the IRS view, both tests would be met at this point—100% of the costs would be incurred and there would be both final completion and acceptance. The common area items are "secondary items" which, under Reg. §1.460-1(c)(3)(ii), are not to be considered in determining the completed status of the contract.

The taxpayer (and, it turns out, the Tax Court) disagreed with that view. The taxpayer pointed out that substantial costs were being incurred with regard to the common areas, their marketing emphasized the value of such amenities, and buyers were clearly willing to pay extra to have a home in a community with such items.

The IRS argued first that, regardless of this fact, the contracts did not cover the common area. The IRS points to the fact that the individual purchase and sale agreements for each home stated that it constituted the sole and entire agreement between the buyer and seller. Thus, since these contracts did not contain the details of the common areas, they simply weren't part of the contract.

However, the Tax Court noted that the contracts made reference to documents that did contain that information. The court analyzed the laws of the states involved (Arizona, California and Colorado) and, based on the specific laws of each state (including requirements in Arizona and California regarding receipt of a developer's public report containing such details) and determined that, despite the specific clause, courts in all of the states would have found the documents detailing the developer's responsibilities for the common areas to be incorporated into the contract. As well, in each case the contracts contained a checklist indicating the documents were to be given to the customers and each customer actual received the documents.

The IRS next contended that the house alone was the "subject matter" referred to in the regulations. The IRS did have one issue to deal with here—because qualification under the 80% rule would be very difficult for a builder such as this taxpayer with significant costs that are not direct costs of the dwelling unit and improvements to it, Reg. §1.460-3(b)(2)(iii) allows a taxpayer to consider the "allocable share of the cost the taxpayer expects to incur for any common improvements."

The IRS position was that the inclusion of these items was solely for meeting the 80% test and did not mean the items became part of the subject matter of the contract. The IRS argued this was in line with the "plain meaning" of the regulation. The Tax Court found that view wanting, holding specifically that if they were to decide upon a "plain meaning" of the subject matter, the Court would determine the subject matter would include the common improvements.

As well, the Court points to the "all facts and circumstances" clause in the second test, which it finds suggest a broad, rather than narrow, view of what constitutes the subject matter.

The IRS's final objection is that, even if the improvements are part of the subject matter of the contract, they are nevertheless the "to be ignored" secondary items discussed in the regulations. All parties agreed that an item should be considered a "secondary item" if the contracting parties intended the item to be secondary.

The Court here finds that, in the facts in this case, the amenities were of "great importance to and a crucial aspect of SHI's, SHLP's, and Vistancia's sales effort, obtaining of governmental approval of the development, and the buyers' purchase decision, and thus the amenities are an essential element of the home purchase and sale contract." Earlier the Court had noted that, given the expense involved with the common areas and amenities, buyers would reasonably be aware that if they were not interested in such items, they could likely obtain a comparable home for far less money in a development without such "extras" and thus they were willing to pay more.

The IRS also looked to try to use a technicality, arguing that the taxpayer had impermissibly aggregated the contracts and, regardless of whether permissible, had failed to attach the required statement with the return when contracts were aggregated. [Reg. §1.460-1(e)(4)]

The Court noted that the method used did not actually aggregate the contracts into a single mass—rather, each contract was tested with its costs and its share of the common costs for purposes of 95% test. Similarly, the mere fact that all of the contracts looked to the promised completion of work on the amenities as one of their conditions for final completion and acceptance would also not be combining them all—as should be clear, each buyer's contract contained portions only of interest to that buyer. So if the taxpayer had completed the amenities but, say, neglected to complete work on the one buyer's garage all other contracts may be complete, but the one would not.

While this case is generally very good news for developers of residential projects, it is important to note that the Court spent significant time on developing both the specific facts related to each project (including how each project was marketed to customers) and details of applicable state law.

Thus any taxpayer seeking to stake out a similar position would be well advised to study the details of the facts in this case and assure that their facts are similar enough to justify reliance on this case. For instance, if there was not a homeowner's association to be involved due to no common amenities and the only common costs were items required by a locality, it might be far more difficult to show that the buyers truly considered those items as anything but "secondary" items.

Section: 461
No Current Deduction Allowed for Unredeemed Portion of Customer Loyalty Program Discounts, as Fact of Liability Not Yet Established

Citation: Giant Eagle Inc. v. Commissioner, TC Memo 2014-146, 7/23/14

In the case of *Giant Eagle Inc. v. Commissioner,* TC Memo 2014-146, http://ustaxcourt.gov/InOpHistoric/GiantEagleMemo.Haines.TCM.WPD.pdf, the IRS and the taxpayer disagreed over whether the taxpayer could claim a deduction related to the unredeemed balance due on its customer rewards program.

Customers who made qualifying purchases at the taxpayer's grocery stores would earn "fuelperks!" that were redeemable as a discount against gasoline purchased at gas stations owned by the taxpayer. The taxpayer was accruing the estimated redemption amount of such "fuelperks!" against its income as of the end of the year.

Generally the proportion of rewards that will eventually be redeemed by customers can be very accurately predicted by the issuer. And, generally, the entity will need to accrue that estimated redemption amount as a liability on the entity's GAAP financial statements.

However under the tax law the potential liability has to generally satisfy the "all events" test under IRC §461 found at Reg. § 1.461-1(a)(2)(i) requires the taxpayer to show:

- All the events have occurred that establish the fact of the liability;
- The amount of the liability can be determined with reasonable accuracy; and
- Economic performance has occurred with respect to the liability.

The IRS argued that the first of these requirements had not been met—until a customer purchases fuel, all events that establish the fact of the taxpayer's liability have not yet been established.

The Tax Court looked at two key cases from the Supreme Court. In *United States v. Gen. Dynamics Corp.*, 481 U.S. 239 (1987) the Supreme Court held that an employer could not deduct amounts due under its self-insured medical plan until employees had actually submitted claims. The court found that no liability existed until a claim was submitted, since for various reasons a person might not file a claim to which he/she is entitled.

Alternatively, in the case of *United States v. Hughes Props., Inc.*, 476 U.S. 593 (1986) the Court found that a casino could deduct the outstanding liability for a progressive slot-machine jackpot where state law forbid the casino from reducing the payout on such a slot machine until it was actually paid out to someone. The fact that it might not be paid out for a long time, or perhaps never if the casino went out of business, did not cause the Court to find the fact of the liability had not been established, even though the casino could not know to whom the jackpot would eventually be paid.

The Court found that this case was more in line with the *General Dynamics* fact pattern—until customers actually bought gasoline, there was no liability.

The taxpayer then turned to a backup position they had—that their program was covered by the "trading stamps" regulation found at Reg. §1.451-1(a)(1). That regulation provides:

> If an accrual method taxpayer issues trading stamps or premium coupons with sales, or an accrual method taxpayer is engaged in the business of selling trading stamps or premium coupons, and such stamps or coupons are redeemable by such taxpayer in merchandise, cash, or other property, the taxpayer should, in computing the income from such sales, subtract from gross receipts with respect to sales of such stamps or coupons (or from gross receipts with respect to sales with which trading stamps or coupons are issued) an amount equal to--
>
> > (i) The cost to the taxpayer of merchandise, cash, and other property used for redemption in the taxable year,
> >
> > (ii) Plus the net addition to the provision for future redemptions during the taxable year (or less the net subtraction from the provision for future redemptions during the taxable year).

The taxpayer argued their program was like the trading stamps described in the regulation.

The Tax Court did not agree. Rather the Court found persuasive the position outlined by the IRS in Revenue Ruling 78-212 that a program of issuing discount coupons that were not directly redeemable in merchandise, cash or other property, but rather simply gave discounts, was not a program described by the above regulation. A customer generally needs to purchase product from the taxpayer (in this case gasoline) in order to obtain the benefit.

The taxpayer argued that if a customer obtained enough "fuelperks!" that he/she could end up a free tank of gas. The Court held that the mere possibility that someone could obtain the free tank wasn't enough. As the Court pointed out, that still required another transaction, and obtaining a free tank depended on the price of fuel when redemption was sought, since each "fuelperk!" gave the customer a 10 cent per gallon reduction in price.

Section: 461
Signing Contract Did Not Establish Fact of Liability and Inconsistent Financial Statement Reporting Renders Item Material

Citation: Veco Corporation v Commissioner, 141 TC No. 14, 11/20/13

In the case of Veco Corporation v Commissioner, 141 TC No. 14, http://www.ustaxcourt.gov/InOpHistoric/VecoDiv.Marvel.TC.WPD.pdf, a question arose about the application of the "all events test" under IRC §461 and the recurring item exception to the economic performance rules under IRC §461(h)(3). Specifically, the Court was looking to clarify whether signing of a contract by itself establishes the fact of a liability as well as the impact of inconsistent financial statement reporting.

The taxpayer in this case filed a Form 3115 Change of Accounting Method with regard to a number of expenses. The Tax Court noted that on the form the taxpayer claimed that it previously on its tax returns had deducted these expenses:

> "(1) with respect to liabilities for which economic performance was satisfied by payment, petitioner capitalized the liability and amortized the payment over the life of the agreement; (2) with respect to liabilities for which economic performance was not satisfied by payment, petitioner deducted the liabilities 'in the period to which they relate.'"

The corporation sought to accelerate these deductions, per the Court:

> "(1) deduct liabilities in the year incurred under the all events test, with modifications under the recurring item exception for insurance and maintenance agreement payments; and (2) with respect to rent liabilities for which economic performance is not satisfied by payment, deduct the liabilities 'in the year the liabilities are fixed and determinable with reasonable accuracy, and where economic performance has occurred'."

This change would have the effect of accelerating the deduction for income tax purposes on the corporation's tax returns.

The all events test, as defined in Reg. §1.461-1(a)(2)(i), allows a deduction to an accrual basis taxpayer in the year in which all of the following are established:

- All events have occurred to establish the fact of the liability
- The amount of the liability can be established with reasonable accuracy and
- Economic performance has occurred with respect to the liability

If any of those cannot be established, the deduction is delayed until a later year. However, in some cases the taxpayers can rely on the recurring item exception to qualify for the economic performance test.

The IRS did not dispute in this case that the corporation could establish the amount of the liability, but questioned whether the fact of the liability existed in each of these case and to the extent that the fact of the liability could be established for any particular expense whether economic performance occurred (including whether the expense qualified for the recurring item exception).

The taxpayer argued that the execution of various service agreements in this case established the fact of the liability. However, the Court pointed out that merely executing a contract by itself does not fix the fact of a liability, since in many cases the contract provides for mutually dependent promises—so the taxpayer would not necessarily have any liability until the other party performs under the contract.

While the taxpayer cited a number of cases it claimed indicated that signing the contract established the fact of a liability, the Court distinguished those cases by noting that in each case it looked in detail at the relevant contract to determine if liability existed in time to claim the deduction. In two cases, the contracts were unilateral contracts with no required performance by the other party. In three cases one party had performed under the contract but payment was not made until the following year—but in the taxpayers' situations no performance occurred until after the year in which the taxpayer sought to claim the deductions.

For a bilateral service contract, an expense generally may not be deducted before the performance of services. Reviewing the information available (not all contracts were introduced in evidence), the court found that performance had not occurred on those contracts, thus the fact of the liability was not established for the service contracts involved.

The Court noted that insurance contracts are tested under similar rules as service contracts and, again, found that performance had not take place on the insurance contract that represented one of the items the taxpayer was seeking to accelerate recognition of the expense.

For rental contracts, the fact of the liability is established as each payment becomes due. Thus, in the case at hand the fact of the liability for a contract providing the payment must be made prior to the month was established on the March 31 year end date for the April rent, but that was not true for a lease that required payment on the first day of the month of the lease. The fact of that liability was not established until one day after the year end.

The Court then goes on to discuss the 3 ½ month rule applicable to the provision of services or property to the taxpayer under Reg. §1.461-4(d)(6)(ii). Under that rule economic performance occurs upon payment if the taxpayer can establish that provision of services or property to the taxpayer is reasonably expected to occur within 3 ½ months after the payment. In this case the taxpayer conceded that this did not occur.

However the Court now turns to the recurring item exception. A taxpayer may treat an item as incurred in a tax year if all of the following are true:

> (ii) economic performance with respect to such item occurs within the shorter of--
>
> > (I) a reasonable period after the close of such taxable year, or
> >
> > (II) 8 1/2 months after the close of such taxable year,
>
> (iii) such item is recurring in nature and the taxpayer consistently treats items of such kind as incurred in the taxable year in which the requirements of clause (i) are met, and
>
> (iv) either--
>
> > (I) such item is not a material item, or
> >
> > (II) the accrual of such item in the taxable year in which the requirements of clause (i) are met results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs.

The IRS claimed the taxpayer failed to meet the economic performance requirement, as well as failing to show the items were either immaterial or that it resulted in a more proper match—the latter due to inconsistent financial statement reporting for the items in question.

The taxpayer did not attempt to argue the "more proper match" test, relying exclusively on the materiality test.

The Tax Court notes that financial statement reporting of an item effectively establishes it as a material item for tax purposes, but that the reverse is not necessarily true. The taxpayer attempted to provide an analysis of the materiality of the item by looking at other factors, but the Court refused to consider that issue—the fact they had pushed these expenses into the following year for financial statement purposes was held to be an admission they were material.

Section: 465
Moving Company's Accrued Liability for Goods Damaged in Transit Does Not Qualify for Recurring Item Exception

Citation: Chief Counsel Advice 201442048, 10/17/14

In Chief Counsel Advice 201442048, the question was whether a moving company was eligible to use the recurring item exception under Reg. §1.465-5 for expenses related to its liabilities to pay for damaged goods.

The recurring item exception is an elective method provided for in Reg. §1.465-5 that allows an accrual basis taxpayer to deduct certain expenses in a year prior to the year in which economic performance occurs.

Generally under the recurring item exception, a qualifying expense can be deducted by an accrual basis taxpayer in the current year if economic performance occurs before the earlier of:

- The date the taxpayer timely files a tax return for the year in question or
- The date that is 8 ½ months after the year end of the taxpayer

If a taxpayer pays a qualifying expense after filing the return, but before the end of the 8 ½ month period, the taxpayer may file an amended return to claim a refund.

Not all expenses qualify for the recurring item exception. Most significantly in this case, the recurring item may not be used for expenses for which specific economic performance rules are not provided by the law, regulations, revenue ruling or revenue procedure.

The memorandum concludes that the only provision which might arguably provide economic performance rules for these expenditures are the rules related to liabilities arising out of the provision of insurance or a warranty or service contract found at Reg. §1.461-4(g)(5). However, the ruling concludes that these payments are none of those items—rather the clauses in their contracts with customers serve solely to limit the general liability the taxpayer would otherwise have for damages to goods while they are being transported.

Since no specific rules for economic performance are provided in the law, regulations, revenue rulings or revenue procedures for these sorts of damage claims, they are not eligible for a recurring item election.

Section: 469
Portion of Proprietorship Business that was Truly Real Property Trade or Business Not Documented, Taxpayer Denied Real Estate Professional Status

Citation: Cantor v. Commissioner, TC Summary Opinion 2014-103, 11/6/14

Passive activity issues have been the subject of quite a few Tax Court cases over the past year, but in the case of *Cantor v. Commissioner*, TC Summary Opinion 2014-103 the issue in front of the Court was one that doesn't quite as often come up. However, the result was again dictated by the same problem that has dogged taxpayers in far too many of these cases—an inability to offer up documentation to prove the taxpayer met the requirements to obtain a preferential tax result.

The issue in this case was whether Howard Cantor was truly a real estate professional under IRC §469(c)(7) for the year in question. The focus was, this time, on whether Mr. Cantor's full time work for the proprietorship that he owned has hours of service qualifying as "real estate" hours.

Real estate professionals qualify for an exception from the general rule that rental are passive activities under §469(c)(2). If a taxpayer is a real estate professional, the rental activities rather are treated just like any other activity—the taxpayer must still demonstrate material participation, but at least the taxpayer has the opportunity to do so.

To be a real estate professional, a taxpayer must meet the criteria found in IRC §469(c)(7)(B). That section provides:

> (B) Taxpayers to whom paragraph applies
>
> This paragraph shall apply to a taxpayer for a taxable year if
>
> > (i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
> >
> > (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.
>
> In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements. For purposes of the preceding sentence, activities in which a spouse materially participates shall be determined under subsection (h).

Real property trades or businesses are defined at IRC §469(c)(7)(C) which states:

> For purposes of this paragraph, the term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Mr. Cantor operated a proprietorship, ABS Glass, which provided various services. Initially it limited its operations to providing automobile parts, but later expanded its business to include automobile windshield repairs and replacements and, later on, repairs and installation of glass products in buildings, holding a state contractor's license for the final category of work.

Mr. Cantor worked 45 to 50 hours per week in the business, performing the normal functions of a proprietor. So, as the Court noted, he clearly spent more than 750 hours in the business. But he did not maintain any contemporaneous record of how many hours he spent performing activities related to the automotive or residential portion of the business, as well as how much related to general management functions.

The taxpayers contended that the residential operations of ABS Glass were construction or reconstruction activities and that Mr. Cantors hours working in that function were both more than 750 hours and more than half of his personal services for the year.

The Court first looked at whether the taxpayer was correct in holding that all of ABS Glass's residential operations constituted a real property trade or business. The Court did not accept that everything that ABS Glass's residential division did qualified as "construction" or "reconstruction" under IRC §469(c)(7)(C). Noting that neither the statute, regulations or case-law has a clear definition of either term, the Court turned to the terms' general usages and concluded:

> *Webster's II New Riverside University Dictionary* 303 (1984) defines the term "construction" as "[t]he act or process of constructing" and defines the term "constructing" as "[t]o put together by assembling parts". *Webster's II New Riverside University Dictionary* 983 defines the term "reconstruction" as "[t]he actor result of reconstructing" and defines the term "reconstructing" as "[t]o construct again." Nothing in the dictionary definitions limits the terms to real property construction or reconstruction, but the statute expressly imposes such a limitation.
>
> Keeping that limitation in mind, we assume without finding that installing original or replacement windows in newly built or existing buildings constitutes "construction" or "reconstruction" within the meaning of section 469(c)(7). On the other hand, we find that cutting and installing mirrors and table tops, cutting and installing shower and bath glass enclosures, and replacing window panes do not.

So, at best, only a portion of the residential activity of ABS Glass might qualify. However, the Court does not need to worry about this because, it notes, Mr. Cantor has no records to allow any sort of division of time:

> Section 469(c)(7)(B) requires that we compare the time petitioner spent in real property trades or businesses against the time he spent in other trades or businesses during each year in issue. Petitioner explained the services he provided as the sole proprietor of ABS Glass in generalized terms, and his explanation shows that he performed services in real property trades or businesses as well as other types of trades or businesses. He did not keep a contemporaneous log showing how much of his time was spent in any particular activity, and we cannot otherwise make that determination from his testimony or any of the other evidence admitted in this case.
>
> Because petitioner provided services in both real property trades or businesses and other trades or businesses during the years in issue, and because the evidence does not allow for a finding that he spent more time in the real property trades or businesses than he did in the other trades or businesses during either year in issue, he is not an individual described in section 469(c)(7) for either of those years. It follows that the real estate loss deductions here in dispute are subject to the limitations imposed in section 469. Respondent's determinations in that regard are sustained.

So while the issue was different than that of most earlier cases, yet again a taxpayer's failure to keep adequate records of his activities doomed his ability to claim real estate professional status.

Advisers need to counsel client who want to claim this status that a failure to maintain records will almost certainly be fatal to claiming real estate professional status should the issue be raised on examination. As well, taxpayers should be made aware that the large number of cases being seen mean that an even larger number of examinations are taking place where the IRS is questioning this issue.

Finally, if an adviser is face to face with a client who decides that a) he can't be expected to keep such records and therefore won't do so but b) wants the adviser to claim the loss anyway because "I probably won't be audited", the adviser must remember the standards an adviser must adhere to in tax practice.

If the adviser "gives in" to such demands, not only is the advisers' own right to practice put in jeopardy, it's very possible that once the IRS becomes aware in examinations that the adviser is "flexible" in this manner that the agency might take an interest in other client's returns—thus risking examinations for clients who have not taken such aggressive positions, but nevertheless will still face the pain of an examination. Even a "no change" examination is a highly stressful event that most of your clients would prefer not to experience.

Section: 469
Taxpayer Met Material Participation Standard Based on the "Facts and Circumstances" Test

Citation: Wade v. Commissioner, TC Memo 2014-169, 8/20/14

The Tax Court found an application for the "facts and circumstances" test for material participation in an activity for purposes of IRC §469's passive activity rules in the case of *Wade v. Commissioner,* TC Memo 2014-169, http://www.ustaxcourt.gov/InOpHistoric/WadeMemo.Goeke.TCM.WPD.pdf.

In the case in question the IRS was treating over $3 million in losses of the taxpayer as passive losses, while the taxpayer claimed to meet the material participation standard. The main issues involved two related S corporations, shares of which were held by the couple in question.

Mr. Wade had founded the original company in question in 1980, and developed the processes used by both companies in their manufacturing process and established and managed their industrial facilities.

In 1994 Mr. Wade's son left his job with Lockheed Corp., moved to Sulphur, Louisiana where the companies were located. and became involved with the business. The son received stock and handled the day to day management of the entities. Mr. Wade moved away to Florida and concentrated primarily on product and customer development from his (now remote) location.

In the economic crisis of 2008 the company's began to struggle financially. To boost morale, Mr. Wade made three trips to the company's facilities to assure employees the company would continue to operate. He also increased his research and development activities during this time, inventing various new techniques of use to the businesses. He also obtained a new line of credit for the companies to assure that there would be adequate cash available.

The IRS argued this was all well and good, but Mr. Wade failed to show he had material participation in the activity. While the court doesn't directly explain the IRS's conclusion, most likely the IRS decided that when Mr. Wade left the area and moved to Florida, he no longer was materially participating in the activity.

Mr. Wade argued that he met the 500 hour test in 2008 and, as well, met the facts and circumstances test. The Court did not address the first test because it found he clearly met the second test.

To meet the "facts and circumstances" test of Reg. §1.469-5T(a)(7) the taxpayer have a minimum of 100 hours of participation and show that he participated in the activity on a regular, continuous and substantial basis.

The Court found he had shown 100 hours of activity and, concluding that without Mr. Wade's actions the company would have failed that the actions met the "regular, continuous and substantial" basis test for 2008.

Specifically the Court found:

> TSI and Paragon are complex businesses that Mr. Wade built from the ground up and in which he continued to play a vital role. He was not merely a detached investor, as has often been the case when we have found that a taxpayer did not materially participate.

Section: 469
Failure to Show Taxpayer Had Either More Hours in Real Estate Than at Other Job and More Than 750 Hours in Real Estate Fatal to Claimed Real Estate Professional Status

Citation: Graham v. Commissioner, TC Summary 2014-79, 8/19/14

The IRS continued its generally successful crusade in the Tax Court against taxpayers who have "regular" jobs not related to real estate in attempting to claim real estate professional status in the case of *Graham v. Commissioner*, TC Summary 2014-79, http://ustaxcourt.gov/InOpHistoric/GrahamSummary.Nega.SUM.WPD.pdf.

Mr. Graham worked as a salaried employee for two wireless phone carriers in the year in question in addition to owning a number of rental properties. He claimed a deduction for the rental losses by claiming he qualified as a real estate professional under the provisions of IRC §469(c)(7) and therefore those losses were not subject to limitation as being passive activity losses.

In order to qualify as a real estate professional, Mr. Graham has to meet the two-pronged test found at IRC §409(c)(7)(B) which provides:

> Taxpayers to whom paragraph applies. This paragraph shall apply to a taxpayer for a taxable year if—
>
> > (i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
> >
> > (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

In this case, Mr. Graham must show he spent more time on the real estate activities each year than he did as a salaried employee of the two wireless carriers and that his hours in the real estate activities exceeded 750 hours. The Court found Mr. Graham failed to demonstrate that he met either of the two tests.

The taxpayer argued that, being a salaried employee, the carriers did not maintain time sheets on his activity. And, as well, he did not maintain a time log, rather estimating his time.

His initial estimate for 2008 had him performing 917 hours in the real properties and 1,640 hours working for a wireless carrier. However, he later "discovered this was an error" and reduced his hours working for the carrier and found additional rental time.

He also introduced letters from other employees at the carrier to attempt to document that he really didn't work that much there—but these letters included some from individuals who admitted they did not work at the carriers during the years in question.

As well, even though he had a W-2 from the second carrier in 2009, he did not include any hours working for the second carrier in his "other activities" summary.

The records for hours at the rentals were reconstructed during the exam and the Court found a number of entries that appeared to claim excessive hours for the claimed work, found unlikely a claim that he met with the tenant of a property five times during the year when no rent was received on that property and that every entry for showing a property ended up with a recorded time of exactly two hours.

Thus the Court found neither set of records persuasive to prove the points that Mr. Graham had to show and the passive losses in excess of passive income were disallowed on the returns.

Section: 469
Aircraft Was Separate Activity from Business, Taxpayer Failed to Show Material Participation

Citation: Williams v. Commissioner, TC Memo 2014-158, 8/5/14

Under the "passive activity" provisions of §469, it is important to first properly determine what constitutes an activity and then determine if the taxpayer can show material participation in that activity. The taxpayer in the case of *Williams v. Commissioner*, TC Memo 2014-158, http://ustaxcourt.gov/InOpHistoric/WilliamsMemo.Buch.TCM.WPD.pdf failed in his arguments relating to both counts.

What constitutes an "activity" is determined by definitions found in Reg. §1.469-4(c) which looks at what constitutes an appropriate economic unit. Factors listed in that regulation, which were noted by the Court, include:

- Similarities and differences in types of trades or businesses;
- The extent of common control;
- The extent of common ownership;
- Geographical location; and
- Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

Mr. Williams had a business giving telephone training seminars. Originally he had worked for his father in the business and had persuaded his father that he, being a licensed pilot, should be able to charter planes to fly to the seminar locations to avoid the hassles of commercial flights. However, this proved costly and it was abandoned.

After his father passed away Mr. Williams did additional research and determined that he could purchase a plane and lease it to flight schools in order to help offset the costs. For the year in question the plane was leased out to flight schools that had the right to use the plane, with Mr. Williams being able to use it for his business only if the school did not have it already booked.

Mr. Williams argued the phone training seminar business and the aircraft operations were one activity. However, the Tax Court, applying the tests noted above, found they had little to do with each other—rather, the rental of the plane was a separate economic activity from the seminar business.

The next key problem is showing material participation under the rules for passive activities. Mr. Williams had argued that he met the 500 hour test when treating the seminar and aircraft activities as one, but since the Court rejected that rule he next fell back on two other possibilities provided to demonstrate material participation under the regulations:

1. He spent more than 100 hours in the activity and no person spent more time *or*
2. He met the "facts and circumstances" test (which also requires a minimum of 100 hours of participation)

The first test, in particular, was one Mr. Williams had uncovered in his research on leasing planes to flight schools. In fact, his agreement with the schools specified that the schools were aware Mr. Williams wanted to show material participation and thus each school agreed no employee would perform more than 100 hours related to the plane.

Unfortunately Mr. Williams had very little to show what hours he had spent on the activity. The largest block of time for which he could provide support involved his claimed daily activity of arguing about maintenance bills. However, Reg §1.469-5T(f)(2)(ii)(A) provides that work as an investor does not count towards material participation—and this "studying the bills" approach is exactly, in the Court's view, the sort of activity an investor would conduct.

His other time was based solely on his after the fact estimates, which the Court ignored as it normally does. Thus, the Court found that Mr. Williams failed to show that he had 100 hours of participation and thus, he could not meet either test he argued he should meet.

Section: 469

Admissions Made in Lawsuit Challenging Whether President of S Corporation Earned His Compensation Used Against President in His Claim that Self-Rental Rule Did Not Apply

Citation: Schumann v. Commissioner, TC Memo 2014-138, 7/14/14

In the case of Schumann v. Commissioner, TC Memo 2014-138, http://www.ustaxcourt.gov/InOpHistoric/SchumannMemo.Kerrigan.TCM.WPD.pdf, a number of issues related to passive activities and rental real estate were before the court. However an interesting issue arose as a taxpayer discovered that positions taken in one legal proceeding can come back to haunt the taxpayer in another.

The case is one of a series of cases of a taxpayer who has substantial income arising from trades or businesses that are not real estate trades or businesses attempting to avail himself of the real estate professional designation. This case is unique first due to the amounts claimed—the losses in question soared to the seven figure range for 2009, the second year at issue.

However the facts and results aren't that unique—the taxpayer could not present records of his actual activity, and what was submitted that purported to be a timely record had inconsistencies that caused the court to reject the evidence.

But a couple of side issues were of note. First, a pair of commercial rentals (which generated net income) were at issue regarding whether they were covered by the self-rental provisions of Reg. §1.469-2(f)(6). Under that rule, if a taxpayer rents property for use in a trade or business in which the taxpayer materially participates, an amount of gross rental income equal to the net rental income is treated as from a nonpassive activity.

The effect of this is to still treat any net loss from the activity as passive, but once the activity shows net income that net income cannot "free up" passive losses from other activities.

The taxpayer in this case rented the properties to two S corporations in which he was both president and majority shareholder. As the court noted:

> Petitioner's tax reporting suggests that he was an active participant in both businesses in 2008 and 2009. For 2008 petitioner reported $5,375,000 of wages from P-Q Controls and $10,000 of wages from P-Q Controls Maine. On his Schedule E he reported $21,643 and $729,959 of nonpassive income from P-Q Controls Maine and P-Q Controls, respectively. For 2009 petitioner reported $856,989 of wages from P-Q Controls and $10,000 of wages from P-Q Controls Maine. On his

> Schedule E he reported $371,525 of nonpassive income from P-Q Controls Maine and $659,223 of nonpassive loss from P-Q Controls.

The taxpayer argued that his reporting for the year was "tax provisioning" and that, in reality, he provided effectively no services to either company for the year. Ignoring the other tax issues this clearly raises, the court pointed out that the taxpayer did admit to reviewing the monthly financial statements and communicated regularly with management of the companies.

One fact that initially seemed a "good" one for the taxpayer was that his adult children, all minority shareholders of one of the companies, agreed with their father's view of what he was not doing for the companies. Unfortunately for the taxpayer they decided, based on that fact, to sue their father in court over the fact that he was doing minimal work (and, presumably, failing to earn the seven figure salary he had been paid in 2008) for the company.

The taxpayer denied that charge, and the Tax Court noted that in depositions:

> Petitioner admitted that he was responsible for ensuring that P-Q Controls had enough resources to invest capital in new projects. Petitioner also admitted that he was involved actively in sales calls during 2008 and 2009. Petitioner also stated that as of the date of the deposition, he was still with P-Q Controls "creating and inventing" and continued to be "a participant in the overall strategy and growth of the business."

While his children might have doubted that story, the fact that the taxpayer took that position in the other legal proceeding led the Court to conclude he had conceded enough activity to be deemed materially participating in the activity—and, thus, the net income from the rentals were not passive income.

Section: 469
Determination of Whether Taxpayer is a Real Estate Professional Not Affected by Election to Combine Rental Activities

Citation: Chief Counsel Advice 201427016, 7/3/14

In Chief Counsel Advice 201427016 (http://www.irs.gov/pub/irs-wd/201427016.pdf) the IRS addressed the question of whether there's an impact on whether a taxpayer may qualify as a real estate professional depending on whether or not the taxpayer makes an election to combine rental properties under Reg. §1.469-9(g).

The issues arises because, as the memo notes:

> Under Treas. Reg. §§ 1.469-9(b)(5) and (c)(3), only time spent in real property trades or businesses in which the taxpayer materially participates under Treas. Reg. § 1.469-5T counts towards meeting the requirements of being a qualifying taxpayer.

However, a real estate professional must test each rental separately unless there is an election made under Reg. §1.469-9(g). As the memo also notes:

> In accordance with section 469(c)(7)(A), each interest of the taxpayer in rental real estate is treated as a separate activity for purposes of determining whether the taxpayer materially participates in the rental real estate activity, unless the taxpayer makes an election to treat all interests in rental real estate as a single rental real estate activity under Treas. Reg. § 1.469-9(g).

So, it would appear, that it would be far more difficult to have the rentals meet material participation unless they are combined.

However, the memo concludes this is not the proper way to look at this. The election under Reg. §1.469-9(g) is only available *if* the taxpayer is a real estate professional. As well, the mandatory separate treatment of the rentals under IRC §469(c)(7)(A) only applies once a taxpayer is a real estate professional.

Thus the memo concludes the proper guidance is found under Reg. §1.469-9(d) which holds:

> The determination of a taxpayer's real property trades or businesses for purposes of [meeting the definition of qualifying taxpayer] is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services. Depending on the facts and circumstances, a real property trade or business consists either of one or more than one trade or business specifically described in section 469(c)(7)(C).

Under that guidance, applied before a taxpayer is deemed to be a real estate professional, the taxpayer can combine the real properties with the underlying trade or business for purpose of meeting the 750 hour test to be a real estate professional.

Effectively, once the taxpayer is determined to be a real estate professional, the grouping is "broken" by §469(c)(7)(A)—but only after the qualification.

Note that the taxpayer may have won only a temporary reprieve—though the taxpayer is now a real estate professional, having failed to elect to combine the rental activities the taxpayer may find it much more difficult to get an actual deduction for losses on the rental. But at least the taxpayer will have the option.

Section: 469
Dispute over Repossession Existing at Year End Meant No Fully Taxable Disposition in Tax Year

Citation: Herwig v. Commissioner, TC Memo 2014-95, 5/20/14

The existence of a dispute related to the foreclosure of rental property that was not settled by the end of the tax year meant the taxpayer had not had a fully taxable disposition of the entire rental activity in the case of Herwig v. Commissioner, TC Memo 2014-95, http://bit.ly/TCMHerwig.

Generally under IRC §469(g)(1)(A) if a taxpayer disposes of his/her entire interest in a passive activity, any losses in excess of income from the activity is treated as not from a passive activity in the year of the disposition.

In this case the bank foreclosed on the properties in 2008 and issued a Form 1099A to the taxpayers with regard to the foreclosure. At the same time, the bank sued for a deficiency judgment against the taxpayers for the unpaid balance of the loans. The taxpayers filed a counterclaim against the bank.

The taxpayer and the bank settled the claims and counterclaims in an agreement signed in 2011. However the taxpayers claimed a fully taxable disposition of the rental properties on the 2008 return.

The Tax Court found that even though the foreclosure took place in 2008, the prolonged litigation introduced uncertainties into the equation. The Court noted that the taxpayers continued to list the properties on the balance sheets of the partnership return that was filed for 2008 and 2009. By implication that certainly suggests the taxpayers believed there was still some "asset" due from the bank to them.

As well, the Court did not accept a backup theory that when a final partnership return was filed for 2010 that this was the fully taxable disposition. The taxpayers did not offer any proof, beyond the return itself, regarding what had been the "disposition" in 2010

Section: 469
Taxpayer Uses Records of Phone Company and Other Third Party Documents to Establish Material Participation

Citation: Tolin v. Commissioner, TC Memo 2014-65, 4/9/14

In the case of Tolin v. Commissioner, TC Memo 2014-65, http://ustaxcourt.gov/InOpHistoric/TolinMemo.Gale.TCM.WPD.pdf, the Tax Court looked at the adequacy of a taxpayer's documentation of his hours in a passive activity.

In a perfect world clients would have maintained daily, accurate logs of their work in activities which the IRS might challenge as lacking material participation. But, as we all know, the world is far from perfect and very few clients maintain detailed daily records.

That was the case for Stefan Tolin when the IRS challenged his thoroughbred racing activity, arguing that he failed to show that he met any of the material participation tests found at Reg. §1.469-5T(a). The taxpayer argued that he could separately meet three tests, arguing that he had more than 500 hours of participation, had more than 100 hours of participation and no one else had more or the general facts and circumstances test.

The Tax Court only decided if he met the first test since, once deciding he did, there was no point in worrying about whether he met the other ones.

The IRS brought forward its standard, and normally successful at trial, position that the taxpayer had only brought forward a record of hours that had been produced for purposes of the dispute and that did not exist at the time of the activity, or any time reasonably close to that. The IRS argued that his currently claims represented an impermissible "guesstimate" that, based on numerous prior cases, is not adequate to show participation.

However, the Tax Court noted, this time was different. The time summaries were supported by independent corroborative evidence--in this case detailed phone records and travel information. The taxpayer's only real link with Louisiana (he lived in Minnesota) related to the thoroughbred activity, an assertion that was supported by the detail of exactly who he called in Louisiana and places he had been.

As well, those parties gave testimony in support of the taxpayer's assertion about what he did. So, unlike the other cases, this log really just served as a reference to third party, independent evidence in support of his hours--evidence that had been created in many cases by third parties (like his wireless phone provider).

Some of the phone records were no longer available (the phone company didn't keep them that far back), but the Tax Court had no problem using what was available, and which clearly supported the taxpayer's claims, to come to the conclusion that the records the phone company would have produced had their record destruction policy not cropped up, would have supported the taxpayer's claim.

While the case is good news, advisers must remain aware that the vast majority of taxpayers in a similar situation have not fared nearly as well, normally because they never came up with third party documentation to support their summaries they prepared at the time of audit. Advisers should continue to counsel clients that maintaining good, accurate records of hours is the best method of protecting a claim of material participation.

As well, if a client gets an exam notice, the adviser should immediately obtain the client's records of participation and, if they are deficient, consider what types of third party evidence might exist and be available to back up the claimed hours. And, most important, that evidence should be on hand and used to prepare any summaries of hours that the client will be producing for the examination.

Section: 469
Foreclosure Sale is Fully Taxable Disposition for Passive Loss Freeing Test Even If There Is Related COD Exclusion under Section 108

Citation: CCA 201415002, 4/11/14

Under IRC §469(g)(1)(A) a taxpayer who disposes of a passive activity in a "fully taxable transaction" is allowed to free up the passive losses from the activity, thus allowing offset of such losses in excess of passive income against nonpassive income.

However, what if the taxpayer disposed of the property in a foreclosure sale in which there was cancellation of indebtedness income that was excluded from taxation by one of the provisions of IRC §108? Does that exclusion from taxation of the COD income mean that there was not a fully taxable disposition, thus denying the taxpayer the use of the losses?

In Chief Counsel Advice 201415002, http://www.irs.gov/pub/irs-wd/1415002.pdf, the IRS concluded the answer to that question is that the taxpayer *has* made a fully taxable disposition.

The IRS looked at the Senate Committee Report to the Tax Reform Act of 1986 where the passive activity provisions first appeared. The IRS concludes:

> ...the legislative history indicates that Congress intended the term "fully taxable transaction" to refer to a transaction constituting a final disposition of all property used in a passive activity that allows for a full accounting of all income, gains, and losses resulting from the ownership and use of such property in the activity over time. While not explicit in either the statute or legislative history, it is generally understood that Congress did not intend § 469 to be a permanent loss disallowance provision. Rather, taxpayers should be able to deduct net losses from a passive activity at a time when the ultimate economic gains and losses derived from a passive activity are finally ascertainable.

The IRS notes that a foreclosure is a disposition under the tax law, and the foreclosure transaction itself is a fully taxable transaction.

So what about that §108 exclusion? Well, that's not relevant in the view of the memorandum. As well, the memo goes on to note that while IRC §108(b)(2)(F) generally requires considering a reduction of any passive loss carryover when there is an exclusion from income under IRC §108, that reduction only takes place after determining the tax for the year.

The release of the loss carryover takes place in the year of the discharge and therefore that loss does not exist at the end of the year as an attribute to be considered for reduction.

Section: 469
Taxpayer's Attempt to Reconstruct Hours In Activity Found Wanting, Losses Disallowed and Penalties Assessed

Citation: Bartlett v. Commissioner, TC Memo 2013-182, 8/8/13

Taxpayers who fail to keep records will find themselves in a difficult position when it comes time to prove material participation in an activity under IRC §469. The taxpayers in the case of *Bartlett v. Commissioner*, TC Memo 2013-182 (http://www.ustaxcourt.gov/InOpHistoric/BartlettMemo.Kerrigan.TCM.WPD.pdf) discovered this problem the hard way.

The taxpayer in this case was a successful entrepreneur who started a bull breeding operation in addition to his principal business. The individual acquired a 1,941-acre ranch in Idaho to run the breeding operation. There were no buildings on the land, so when the taxpayer was at the ranch he would sleep in his truck, in a motel nearby or in a doublewide trailer parked at the ranch.

The taxpayer had not maintained records of the work he did at the ranch, though various individuals testified that they had seen him there. However, none of them provided information on exactly how much time he had spent.

Mr. Bartlett did have three employees of his business stay on the ranch during the winter months, working approximately 40 hours a week each. He also had an arrangement with an individual who lived nearby in Idaho whereby that individual would be allowed to graze his horses on the ranch in exchange for providing services to the ranch.

Mr. Bartlett claimed that he should be treated as materially participating in the ranch under all of the following provisions found in Reg. §1.469-5T in testing for material participation. First, he claims he performed more than 500 hours of service for the ranch during the year. Second, he claims he worked more than 100 hours and more than anyone else did on the ranch. Finally, he claims he would be properly treated as materially participating under the facts and circumstances test.

To support this claim Mr. Bartlett attempted to reconstruct his time once the exam began by consulting his credit card statements and then attempting to recollect what he did. He also claimed that he spent 7-10 hours per week doing research for the ranch and studying various auctions.

The Court found a number of inconsistencies in the reconstructed records. First, the court noted that the credit card statements themselves provided no information on how many hours Mr. Bartlett had participated in the ranch activity. As well, on some days where Mr. Bartlett claimed to be on the ranch in Idaho, his credit cards reflected charges incurred in the state of Wyoming where he resided. On one occasion the court also found he had claimed to have spent 28 hours in various ranch related activities during one 24 hour period.

Mr. Bartlett also could not provide any records of his significant research activities or his activities making decisions and directing employees on the ranch. The Court found this to be unusual if, in fact, Mr. Bartlett was truly investing all of this time in the research and directing of individuals on the ranch.

The Court found that this was clearly, at best, an after the fact "guesstimate" of his time not derived from any contemporaneous records. The Court found that he could not establish that he had performed in excess of 500 hours of service (or even 100 hours), and as well could not establish that he had actually performed more hours of service than the winter employees or the neighbor. Mr. Bartlett had failed to show that he had materially participated, thus the losses were disallowed on his return.

Mr. Bartlett was also hit with the §6662 substantial understatement penalty. While had retained two CPAs to prepare the returns in question (a different one for each year), he presented no evidence of what information he provided the CPAs or that he had relied on their advice in concluding that he was able to claim material participation. As well, neither CPA testified for the taxpayer at trial.

This case is just one more case of taxpayers with inadequate records failing to survive an IRS challenge with regard to material participation under §469. Advisers should counsel any client claiming to materially participate in an activity of the strict rules regarding documenting such participation and inquire if such documentation exists. Merely "knowing" that he/she "must have" participated more than 500 hours or more than anyone else simply isn't adequate to survive IRS scrutiny.

Taxpayers and their advisers who decide to push forward regardless may find themselves subjected to significant penalties, along the assessment for tax and interest due.

Section: 471
IRS Makes Revision to LCM Retail Inventory Method and Provides for Automatic Accounting Method Change

Citation: TD 9688 and Revenue Procedure 2014-48, 8/15/14

The IRS has issued final regulations (TD 9688, http://www.gpo.gov/fdsys/pkg/FR-2014-08-15/pdf/2014-19275.pdf) under §471 (Reg. §1.471-8) that modify the calculation of inventory under the lower of cost or market retail inventory under IRC §471.

Under the retail inventory method, a taxpayer computes the value of inventory at its retail price and then multiplies that by a factor that is computed based on purchase costs contained in beginning inventory and acquired during the year, based on the following formula:

$$\frac{\text{Beginning Inventory} + \text{Cost of Purchases for Year}}{\text{Retail Price of Beginning Inventory} + \text{Initial Retail Price of Purchases}}$$

The final regulations prohibit a taxpayer from reducing the numerator of the above equation sales-based vendor chargebacks this is related to or intended to compensate for a permanent markdown of retail selling prices.

The regulations apply to tax years beginning after December 31, 2014.

The IRS also issued Revenue Procedure 2014-48, modifying Revenue Procedure 2011-14, http://www.irs.gov/pub/irs-drop/rp-14-48.pdf, which provides for the exclusive method a taxpayer may use to conform its use of the retail inventory method to the final regulations.

A new automatic method change (number 204) is added at section 21.16 of the Appendix to Revenue Procedure 2011-14 to allow for this required change.

The adjustment is to be made on a cut-off basis—thus there will not be §481(a) adjustment computed, but the entire adjustment will be picked up in the year of change. Due to the nature of computation used for retail method, not allowing a cut-off method would have effectively required taxpayers to go back to the first year the taxpayer used the retail method and then recompute ending inventory for each intervening year.

Section: 501
IRS Determines Virtual Sorority Cannot be a Section 501(c)(7) Social Club

Citation: PLR 201434022, 8/22/14

The IRS, deciding that a social club requires an opportunity to meet people "in the flesh" rather than virtually, in PLR 201434022 (http://www.irs.gov/pub/irs-wd/201434022.pdf) denied an attempt by a "virtual" sorority to be found to be a tax exempt social club as defined in §501(c)(7).

The IRS noted that:

> Commingling and the promotion of fellowship are not a material part of your operations. Commingling is a necessary and material part in the life of an organization exempt under§ 501 (c)(7) and is deemed present if such things as meetings, gatherings, and regular facilities are evident. See, Rev. Rul. 70-32, supra, and Rev. Rul. 74-30, supra. Face-to-face interaction is important for members of a social club. Organizations that do not afford opportunities for this personal contact among members are not

> entitled to exemption under§ 501 (c)(7), even though they may be organized not for profit with no part of their earnings inuring to the benefit of shareholders. See, Rev Rul. 55-716, supra. The definition of "club" within the meaning of§ 501 (c)(7) shall be strictly construed. See, United States v. Fort Worth Club of Fort Worth Texas, supra.

The IRS goes on to note that, by its nature, the organization primarily advances the individual interests of its members. That was true even though the organization did hold an annual meeting where face to face interaction could occur—the IRS pointed out that this event was minor compared to how the organization operated for the remainder of the year.

Effectively this ruling holds that a “virtual” social club of any sort would fail to qualify for exemption under §501(c)(7). With the growth of “virtual” activities, conceivably an organization that previously qualified as an exempt social club could, due to changes in the environment it operates in, find that its exempt status might be subject to question as it adds “virtual” elements to its structure and members begin to use the virtual options in lieu of face to face interactions.

Section: 501
Organization Offering Qualified Plans to Attorneys Only Not a Tax Exempt Business League

Citation: ABA Retirement Funds v. United States, CA7, 114 AFTR 2d ¶2014 5081, 7/26/14

The ABA Retirement Funds filed a refund claim with the IRS, arguing the entity should qualify as a business league under IRC §501(c)(6). However, the Seventh Circuit disagreed with this view (*ABA Retirement Funds v. United States*, CA7, 114 AFTR 2d ¶2014-5081, http://caselaw.findlaw.com/us-7th-circuit/1673437.html).

Under IRC §501, one of the allowed tax exempt organization is described at §501(c)(6) as:

> (6) Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

As the Court of Appeals noted, that doesn’t provide a lot of details. So the IRS filled in details at Reg. §1.501(c)(6)-1. That regulation provides:

> A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax. Organizations otherwise exempt from tax under this section are taxable upon their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

In this case ABA Retirement Funds marketed retirement programs to attorneys. In doing so, it received a fee based on a percentage of assets under management by the Plan. The organization also took on the role of creating and maintaining an IRS-approved master tax-qualified retirement plan and took on the role of plan fiduciary. By doing so, the organization relieved employers who adopted their program from being forced to undertake those roles for compliance with ERISA.

As the Court noted, this arrangement competed with other plans in the market—plans run by entities that were subject to income tax on their net earnings.

However, ABA Retirement Funds claimed that they should qualify for §501(c)(6) treatment as their goal was to improve business conditions for the legal profession by insuring attorneys had the peace of mind of knowing they had a plan in place for their retirement.

While the Court of Appeals agreed that it's probably a good thing for attorneys to look after their retirement, that's really no different than for any other group. As well, the principal benefit accrued to the individual attorneys rather than to the legal profession as a whole. The court noted that while a business league could offer a service like this part of its service to the industry, in such a case the item must be incidental to the overall purpose of the organization. However, if such activities become substantial then tax exempt status is not warranted—and, in this case, such activities were the only activity of the organization.

As well, the Court noted this sole activity was one regularly carried on for profit by non-exempt organizations. The Retirement Fund pointed out that one of the requirements for the IRS to grant approval to their retirement was that the organization be "similar to" a business league. Thus, the Retirement Fund argued, the IRS had conceded they were a business league due to having approved the plan.

The Court addressed this by discussing art and baking, of all things. It noted that one might argue a cucumber has characteristics "similar to" a zucchini—that is, it is green and shaped similarly to a zucchini, so that it might, the court argued, to stand in for a zucchini in an impressionist still life.

But similar to doesn't mean that it is a zucchini—and that while its similarity is fine for the still life, it doesn't mean it could then be substituted as an ingredient when looking to bake a loaf of zucchini bread.

Similarly, while the organization was "similar to" a business league for qualified plan purposes, that doesn't mean it is a business league for purposes of being treated as a tax-exempt organization.

Section: 501
IRS Issues Simplified Form 1023 for Small Section 501(c)(3) Organizations

Citation: Form 1023-EZ, TD 9674 and Revenue Procedure 2014-40, 7/1/14

The IRS has issued a simplified application for exemption under IRC §501(c)(3), Form 1023-EZ and associated instructions. The form is available at http://www.irs.gov/pub/irs-pdf/f1023ez.pdf, with instructions at http://www.irs.gov/pub/irs-pdf/i1023ez.pdf. The form is significantly shorter than the 26 page full Form 1023.

At the same time the IRS issued revised final regulations under Section 501 in TD 9674 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-15623.pdf) and an updated Revenue Procedure governing applications for exempt status in Revenue Procedure 2014-40 (http://www.irs.gov/pub/irs-drop/rp-14-40.pdf).

An eligibility checklist with 26 questions is to be used to determine if an organization would be eligible to use this form in lieu of the standard Form 1023 is found in the instructions to the Form 1023 EZ. A yes answer to any of the questions would require the organization to file the longer form.

The new form must be filed electronically, although a three page paper version is provided on the IRS website to allow organization to prepare for the filing. The application is filed electronically at http://www.pay.gov and a $400 user fee applies.

In the April 29, 2014 edition of *PPC's Five Minute Update* it was reported that the IRS expects 70% of §501(c)(3) organizations applying for exemption will be qualified to use the Form 1023-EZ. The document goes on to state that the IRS is looking to reduce the work they are doing in the application phase, probably good news for those applying for exemption. However the report goes on to state that the IRS plans to make up for this by doing more thorough examinations of such organizations.

These changes took effect on July 1, 2014.

Section: 501
Proposed Regulations Would Limit Candidate Related Activities by §501(c)(4) Organizations

Citation: REG-134417-13 , 11/26/13 and IRS Website Release 5/22/14

In REG-134417-13 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2013-28492.pdf) the IRS issued proposed regulations that seek to change the rules regarding permitted political activities of §501(c)(4) social welfare organizations.

Unlike §501(c)(3) organizations, §501(c)(4) organizations have been allowed to have some political campaign related activities. The question of whether an organization has moved from promoting social welfare to being "too" political has been a “facts and circumstances” based test under the regulations. The proposed regulations add a set of specifically proscribed activities for §501(c)(4) organizations.

Under the proposed rules, such organizations would not be allowed to participate in “candidate related” political activities. Proposed Reg. §1.501(c)(4)-1(a)(2)(ii) would be revised to indicate that “[t]he promotion of social welfare does not include direct or indirect candidate-related political activity” and then goes on to define such activities.

The proposed regulation defines such activities at Proposed Reg. §1.501(c)(4)-1(a)(2)(iii):

- Any communication expressing a view on, whether for or against, the selection, nomination, election, or appointment of one or more clearly identified candidates or of candidates of a political party that
    - Contains words that expressly advocate, such as "vote," "oppose," "support," "elect," “defeat,” or “reject;” or
    - Is susceptible of no reasonable interpretation other than a call for or against the selection, nomination, election, or appointment of one or more candidates or of candidates of a political party;
- A communication within 30 days of a primary election or 60 days of a general election that refers to one or more clearly identified candidates in that election or, in the case of a general election, refers to one or more political parties represented in that election;
- A communication the expenditures for which are reported to the Federal Election Commission, including independent expenditures and electioneering communications;
- A contribution (including a gift, grant, subscription, loan, advance, or deposit) of money or anything of value to or the solicitation of contributions on behalf of
    - Any person, if the transfer is recognized under applicable federal, state, or local campaign finance law as a reportable contribution to a candidate for elective office;

- Any section 527 organization; or
- Any organization described in section 501(c) that engages in candidate-related political activity

- Conduct of a voter registration drive or "get-out-the-vote" drive;
- Distributionof any material prepared by or on behalf of a candidate or by a section 527 organization including, without limitation, written materials, and audio and video recordings;
- Preparation or distribution of a voter guide that refers to one or more clearly identified candidates or, in the case of a general election, to one or more political parties (including material accompanying the voter guide); or
- Hosting or conducting an event within 30 days of a primary election or 60 days of a general election at which one or more candidates in such election appear as part of the program.

The regulations contain an attribution rule that will be used to restrict activities of related individuals and the like. The attribution rule, found at Proposed Reg. §1.501(c)(4)-1(a)(2)(C), holds:

> For purposes of this section, activities conducted by an organization include activities paid for by the organization or conducted by an officer, director, or employee acting in that capacity or by volunteers acting under the organization's direction or supervision. Communications made by an organization include communications the creation or distribution of which is paid for by the organization or that are made in an official publication of the organization (including statements or material posted by the organization on its Web site), as part of the program at an official function of the organization, by an officer or director acting in that capacity, or by an employee, volunteer, or other representative authorized to communicate on behalf of the organization and acting in that capacity.

The regulations would be effective upon their publication in final form in the Federal Register.

Not unexpectedly, these proposed regulations generated a lot of controversy. On May 22, 2014 the IRS published the following notice on their website:

> Last November, Treasury and the IRS proposed a new regulation governing political activity of section 501(c)(4) organizations. The proposal generated over 150,000 written comments — the most comments ever received by Treasury and IRS on a proposed tax regulation. Consistent with our standard rulemaking process, we intend to review those comments carefully, take into account public feedback, and consider any necessary changes. Consistent with what Commissioner Koskinen has previously stated, it is likely that we will make some changes to the proposed regulation in light of the comments we have received. Given the diversity of views expressed and the volume of substantive input, we have concluded that it would be more efficient and useful to hold a public hearing after we publish the revised proposed regulation. Treasury and the IRS remain committed to providing updated standards for tax-exemption that are fair, clear, and easier to administer. (http://www.irs.gov/uac/Newsroom/IRS-Update-on-the-Proposed-New-Regulation-on-501(c)(4)-Organizations)

Such statements may mean the IRS really is planning to issue new regulations or that, rather, the "revised" regulations that will be needed before the public hearing may simply never seem to arrive. In either event, not for profit organizations will want to watch to see if the IRS does issue a new set of proposed regulations and, if so, what differences emerge in any new proposed regulations.

Section: 501
IRS Issues Revised Guidance to Agents on State-Chartered Credit Union UBIT

Citation: TEGE Memo TEGE-04-0314-0005, 3/24/14

The IRS issued guidance to agents dealing with state chartered credit unions recognizing IRS losses on issues related to the treatment of certain items of income in TEGE Memo TEGE-04-0314-0005, http://www.irs.gov/pub/foia/ig/spder/TEGE-04-0314-0005%5B1%5D.pdf.

In the cases of *Bellco Credit Union v. United States*, 735 F.Supp. 2d 1286 (2010), and *Community First Credit Union v. United States*, No. 08-cv-0057 (E.D. Wis. May 15, 2009), ECF No. 84 the IRS lost in its attempts to treat certain items as unrelated business income subject to the unrelated business income tax (UBIT).

Specifically both cases found that income from the sale of credit life insurance and credit disability insurance to members of a state chartered credit union was not subject to UBIT. Additionally, the *Community First* case found that the sale of guaranteed auto protection insurance was not subject to UBIT, while the *Bellco* case held that the sale of accidental death and dismemberment insurance was excluded from UBI due to the royalty income exception.

The memo specifically informs agents to treat the following items as not subject to UBIT:

- Sale of checks/fees from a check printing company
- Debit card program's interchange fees
- Credit card program's interchange fees
- Interest from credit card loans
- Sale of collateral protection insurance

However, the agents are to treat income from the following items as subject to UBIT:

- Automobile warranties
- Dental insurance
- Cancer insurance
- Accidental death and dismemberment insurance
- Life insurance
- Health insurance
- ATM "per-transaction" fees from nonmembers

Finally, only income related to sales to members of the credit union for the following items should be excluded from UBIT:

- Credit life and credit disability insurance
- GAP auto insurance

Finally the memo concludes that for all other insurance products, the income can only be excluded from the state-chartered credit union's UBIT if there is a royalty agreement. If the credit union receives a payment for its services in such cases, that payment for services would be UBIT.

Section: 501
Interim Guidance for Functionally Integrated Type III Supporting Organization Supporting a Governmental Entity Issued

Citation: Notice 2014-4, 12/23/13

In Notice 2014-4, http://www.irs.gov/pub/irs-drop/n-14-04.pdf, the IRS provided interim guidance for a Type III supporting organization that is seeking to qualify as functionally integrated by supporting a governmental supported organization. The notice also modifies section 3 of Notice 2006-109 by providing interim guidance on whether a potential grantee is a Type I, Type II or functionally integrated Type III supporting organization for purposes of excise taxes under IRC §§4942, 4945 and 4966.

Until the earlier of the date final regulations are published under IRC §1.509(a)-4(i)(4)(iv) or the first day of the organization's third taxable year beginning after December 31, 2013, a Type III supporting organization will be treated as meeting the requirements of Reg. §1.509(a)-4(i)(4) and be functionally integrated if it:

- Supports at least one supported organization that is a governmental entity to which the supporting organization is responsive within the meaning of § 1.509(a)-4(i)(3); and
- Engages in activities for or on behalf of the governmental supported organization that perform the functions of, or carry out the purposes of, that governmental supported organization and that, but for the involvement of the supporting organization, would normally be engaged in by the governmental supported organization itself.

The notice indicates that these preliminary rules should not be taken to indicate the nature of the final regulations, and specifically warns that an organization will not be able to rely upon this notice after final regulations are published.

The notice also modifies the reliance standards found in Notice 2009-109 where an organization making grants may rely upon a qualified opinion of counsel. That reliance rule will continue to apply, but effective for grants made after December 31, 2012, an organization must meet the requirements described in current Reg. §1.509(a)-4(i)(4) and Section 3.01 of Notice 2014-4 described above.

The notice goes to warn:

> Accordingly, in order to determine that a Type III supporting organization is functionally integrated based on a written representation, a grantor must collect and review a written representation and documents that demonstrate the grantee meets the requirements described in current § 1.509(a)-4(i)(4) or section 3.01 of this notice.

The notice is officially effective December 23, 2013, though provisions are made to rely on this ruling effective as of December 28, 2012.

Section: 501
Organizations Found to Provide Impermissible Private Benefits, Not Operated for Exempt Purposes

Citation: Partners in Charity, Inc. v. Commissioner, 141 TC No. 2 and Capital Gymnastics Booster Club, Inc. v. Commissioner, TC Memo 2013-193, 8/26/13

On the same day the Tax Court ruled that two organizations failed to qualify as tax exempt organizations due to providing an excessive level of private benefit.

The first case, Partners in Charity, Inc. v. Commissioner, 141 TC No. 2 (http://www.ustaxcourt.gov/InOpHistoric/PartnersinCharityTCGustafson.TC.WPD.pdf), the Tax Court revoked the tax exempt status of an organization that provided down payment assistance.

Although the organization's claimed exempt purpose was to provide down payment assistance to low income individuals, the Tax Court found that the organization in reality did not make significant inquiries into the financial status of individuals to which it gave assistance.

Rather, the Court noted the organization required home sellers to pay the organization a fee and the down-payment amount for each home for which assistance was to be given. The organization marketed the program to home sellers, indicating that the program provided sellers with ready buyers, enabled the sellers to sell for higher prices and allowed them to sell faster. The marketing materials trumpeted the claim that by participating in this program the sellers would increase the seller's net proceeds.

The Court ruled that the charity did not actually investigate the need level of those it assisted in practice, and thus found whether it had actually benefitted a disproportionate number of low income individuals was not a relevant consideration—the program simply did not look directly to the factors it claimed would be important in deciding on whom to assist.

Rather the Court concluded this was primarily operated as a commercial operation with only incidental exempt purpose activities that might occur. The Court therefore found the IRS was proper to have retroactively revoked the organization's §501(c)(3) exempt status beginning with its date of incorporation.

The second organization to lose its exempt status in the Tax Court the same day is described in the case of Capital Gymnastics Booster Club, Inc. v. Commissioner, TC Memo 2013-193 (http://www.ustaxcourt.gov/InOpHistoric/CapGymMemo.Gustafson.TCM.WPD.pdf).

This organization also held §501(c)(3) status, in this case organized to support amateur sports competition. The organization supported young athletes of a single local private gym that competed in meets.

Parents of the athletes in question paid tuition and other fees to the gym. The organization was formed to pay the expenses incurred by the athletes in competing at various meets. Participation in the meets required substantial funds beyond those which the parents had paid for the gym tuition and fees.

Membership in this organization was mandatory for parents of athletes who wished to compete in the meets. Each parent was assessed a fee, which ranged from $600 to $1,400, to cover the costs of entry fees and estimated expenses of the coaches' travel to attend the meets.

Parents had the option of either paying the assessment, or participating in the organization's fund raising activities. The amount raised by the parent was credited directly against the assessment due from that parent. If a parent did not participate in the fundraising activity, no assistance was provided to reduce the assessment against that parent.

Specifically, the organization explicitly prevented individuals it called "freeloaders" or "moochers" from receiving any benefit from the fundraising activities. 93% of the fundraising profit was allocated to offset the assessments of parents that participated, leaving only $2,406 for use by the entire organization. The only other income the organization received was from membership fees and assessments.

The IRS asserted that the organization failed to operate exclusively for exempt purposes, and the Tax Court agreed. The Court found that the operation violated the prohibition on private inurement under IRC §501(c)(3) by offering an impermissible benefit to insiders.

The organization contended the arrangement did not give rise to a constructive distribution since it never gave any cash to the parents, and the money went directly to competition related activities. The organization notes that many organizations raise funds that don't jeopardize their exempt status, noting church youth groups, Cub Scouts or public school athletic booster clubs.

The Court did not buy this argument. It notes that a parent's fundraising was earmarked to reduce what otherwise could be a $1,400 payment the parent would have to pay out of his/her pocket. The direct linkage of a parent's fundraising results with paying expenses for that parent's child was a very specific benefit obtained by the insider. While the parent may not have been paid cash, the parent nevertheless ended up escaping having to write a check for the amount of the benefit.

As well, the fundraising in this case (unlike the Cub Scouts and other groups noted above) was admittedly the primary function of the organization. This was "pay when you play" program for parents—parents had the option of either taking on fund raising or simply writing a check.

Thus, the Court found the parents received a significant private benefit from the fundraising that was directly tied to the parent's production. That served as an impermissible private benefit, and thus the organization was not operated for an exempt purpose.

Section: 513
Hospital Providing Lab Service to Nonpatients in Medically Underserved Community Did Not Generate Unrelated Business Income

Citation: TAM 201428030, 7/11/14

In TAM 201428030 (http://www.irs.gov/pub/irs-wd/201428030.pdf) the IRS took a look at whether the operation by a hospital of a laboratory service that service physicians in its area and surrounding communities represented unrelated business income under §513 of the IRC.

In the situation that lead to the TAM, the entity was a nonprofit corporation formed to hold title to hospital buildings, manage, maintain and carry on the hospital. Its bylaws stated that it was dedicated to improving the health status of various communities by enhancing preventative and primary care and providing health education.

The hospital operated a laboratory, with the majority of the laboratory's services being provided to patients of the hospital. However, a portion of the services are rendered to private physicians in the community (which has been designated by the U.S. Census Bureau as a medically underserved community). The hospital had previously been reporting these fees as unrelated business taxable income.

The hospital does not advertise these services nor does it employee individuals as salespeople or to otherwise market the services. There is no full service commercial or noncommercial laboratory facility in the community in question. The closest full service laboratory otherwise available is located hours away.

The hospital represented that the doctors in their area find the shorter turnaround time for tests processed via the local lab provides a critical improvement in the medical care they can offer to their patients, particularly the elderly.

Revenue Ruling 85-110 generally holds that laboratory testing done by a hospital for nonpatients constitutes unrelated business income, but also holds that unique circumstances may exist that would lead to the income not being unrelated business income. The ruling finds that this is one such unique case and that the offering of laboratory services to the nonpatients in this community without adequate access to other options for speedy laboratory testing furthers the organization's stated tax exempt purpose.

Section: 956
Audit Firms Not Found to Be Reckless in Not Treating Advice of Outside Tax Advisers in the Same Fashion as if Made by Management

Citation: In re: OSG Securities Litigation, United States District Court for the Southern District of New York, Docket No. 1:12-cv-07948, 2014 TNT 232-7, 11/28/14

In an auditor's liability case, the question involved whether an auditor should be faced with liability for fraud due to failing to treat advice given by the client's tax adviser as a representation of the client's management, rather than relying on the outside adviser's expertise. In the case of *In re: OSG Securities Litigation*, United States District Court for the Southern District of New York, Docket No. 1:12-cv-07948, 2014 TNT 232-7, the Court found that the auditor had not fraudulently failed to investigate the advice, not agreeing that it amounted to a representation of management.

The tax matter at hand involved the client's liability for tax under IRC §956, related to Controlled Foreign Corporation's investments in United States property. The client's CPA firm handling tax matters had erroneously assessed the entity's liability under that provision.

The plaintiffs claimed that the auditors had a duty to investigate the outside tax CPA's advice as if it had been an assertion of management. As the Court noted in its opinion:

> The crux of plaintiffs' argument is that the Frankel opinions, because they were included in the company's audit file, should have been treated *as* representations made by OSG management. If that is true, plaintiffs argue that PwC and E&Y flouted their investigatory obligations -- and whether this amounted to fraud, or only to negligence, is a factual question that plaintiffs should be able to litigate.

The Court did not buy the theory that the tax CPA's analysis must be treated the same as if it made by the client's management. The Court notes:

> Plaintiffs have cited no case -- nor have I been able to locate any -- that supports the proposition that "a tax preparer' s analysis, independently done . . . is no different [than] if it came from management itself."19 Indeed, the only even analogous authority in the Second Circuit cuts the other way. In *Oleck v. Fischer*, the court held it was reasonable for an outside auditor to rely on an advisory bankruptcy opinion obtained by the company from outside counsel and furnished by the company to the auditor -- i.e., the auditor was under no duty to look past the representations of outside counsel.
>
> *Oleck* is directly relevant to the instant case. And its result speaks to the relationship between company insiders and outside advisors. The reason auditors are required to investigate in-house representations -- indeed, the reason why 10(b)(5) violations occur -- is that managers often have an incentive to distort. There is little reason to think that third-party tax preparers, operating at arm's length from the company, share this propensity. If anything, they have the opposite incentive, because they owe their clients a duty of care, and they face potential liability (unconnected to securities fraud) for performing erroneous calculations.

Thus, the Court found there were no grounds under which to treat the auditors as acting recklessly, and therefore opening the door to a finding of fraud.

The CPA firms aren't totally in the clear. The ruling notes that there is still a question (to be decided in future proceedings) about whether the firms should have discovered the unrecorded liability for the tax due. But that is a question of simple negligence, not one of the auditors acting recklessly to justify a finding of fraud.

Section: 965
Intent to Evade Tax Not Required to Be Shown In Applying §965 Related Party Debt Rules

Citation: BMC Software Inc. v. Commissioner, 141 TC No. 5, 9/18/13

In the case of BMC Software Inc. v. Commissioner, 141 TC No. 5, http://www.ustaxcourt.gov/InOpHistoric/BMCDiv.Kroupa.TC.WPD.pdf, the U.S. Tax Court had to consider whether there was an intent requirement imposed by the language of what would reasonably be seen as an anti-abuse provision. The Court ruled that since no "bad intent" requirement was found in the statute, the statute had to be applied mechanically even if both the IRS and the taxpayer agreed that there was no "bad faith" on the part of the taxpayer.

The provisions in question arose under IRC §965 which allows an 85% dividend received deductions for certain dividends received by a corporation from a controlled foreign corporation (CFC). Such dividends must be "extraordinary" as defined in IRC §965(b)(2), which at dividends paid in excess of prior periods.

In order to prevent a corporation from essentially "funding" a repatriation by loaning the controlled corporation the funds to make the "extraordinary" dividend payment, IRC §965(b)(3) requires that such dividends must be reduced by an increase in related party indebtedness.

In the case in question, the taxpayer had been the subject of an IRS examination regarding royalty payments made to the CFC. The IRS asserted that the dividends were no arms-length and the taxpayer and the IRS entered into a closing agreement in 2007 that reduced the royalty payment.

The taxpayer elected under Revenue Procedure 99-32 to treat the excess payments as loans, resulting in two separate $22 million increases in accounts receivable between the U.S. entity and the CFC. The CFC repaid the U.S. entity the $44 million plus interest. Had the taxpayer not elected this treatment, the payment would have been treated as a contribution of capital to the CFC.

However, the taxpayer had received $709 million of dividends in its fiscal year ended March 31, 2006 eligible for the 85% reduction. The IRS now contended that those eligible dividends must be reduced by $44 million, representing the increase in related party debt during the testing period. That was true even though, clearly, the taxpayer was not even aware the "loan" existed during that period and, as the IRS agreed, did not act in bad faith to "pump up" the repatriation distribution.

The Tax Court ruled that the law had to be applied mechanically, finding there was no requirement of a showing of intent to avoid tax or enter into an abusive transaction.

Section: 1031
Fact That Non-Like-Kind Property Treated as Replacement Property Did Not Invalidate 1031 Exchange When Taxpayer Timely Acquire Other Property That Had Been Identified

Citation: TAM 201437012, 9/13/14

The IRS National Office ruled against a position advocated by agents examining a taxpayer in TAM 201437012.

The issue in this case involved a taxpayer that participated in a like-kind exchange program for equipment, essentially being continuously involved in like-kind exchanges under §1031.

In a particular case in question the IRS agents had determined that property designated as acquired to close out a specific like-kind exchange was not like-kind property. However, the taxpayer had identified other property during the proper identification period for the properties given up and those properties were acquired prior to the expiration of the like-kind replacement period.

The IRS agents argued that because the taxpayer had specified properties as the replacement properties for the properties given up that turned out not to be like-kind, the fact that they had actually acquired other properties timely that had also been identified as potential replacement properties for the transaction in question and which were like kind was not relevant—the gain must be recognized.

The agents pointed out that these properties had been specified as replacement properties for a different transaction, thus creating a domino effect cascading through future transactions. Since the company entered into many such transactions, the agents would need to tediously examine this other transaction to see if the same result could be obtained—likely resulting in yet another transaction that would have to be looked at until such time as the IRS pushed all the way through to transactions as of the date of exam or finally found one where the rules would be violated.

The National Office pointed out that §1031 is not an elective section and it must be applied if the transaction meets its conditions. While the rules require identification of properties being considered as replacement properties without certain time constraints, the law has no rule regarding having to pick which of those properties ultimately will be the replacement. Rather, the first qualifying properties acquired during the replacement period will become the property that is part of the §1031 exchange.

Section: 1060
Allocation of Purchase Price to Buildings in Business Asset Purchase Could Not Be Changed Via Later Cost Segregation Study

Citation: Peco Foods, Inc. v. Commissioner, TC Memo 2012-18, 1/17/12, affd CA 11, Docket No. 12-12169, 7/5/13

Can a taxpayer use a cost segregation study to reallocate a portion of an asset purchase subject to IRC §1060 allocations that were allocated to a building between §§1250 and 1245 components after the fact? The Tax Court dealt with this issue in the case of *Peco Foods, Inc. v. Commissioner*, TC Memo 2012-18 (http://www.ustaxcourt.gov/InOpHistoric/PecoFoods.TCM.WPD.pdf) .

In the case in question the taxpayer had acquired two poultry processing plants in asset purchases of an existing business. In each case the taxpayer and the seller had executed an agreement that included the allocation of the purchase price of the assets, and had allocated a lump amount to, in one case the "processing plant building" and in the other "real property improvements" which the corporation initially treated as commercial real estate with cost recovery over 39 years. In both cases, the allocation schedule provided that the parties would use these values for all purposes including tax and financial reporting.

Later the corporation engaged an expert to perform a cost segregation study on the properties in question and determined that a portion of each "building" was actually not real property for tax classification purposes, but rather property eligible for more rapid depreciation. The corporation reclassified such items and filed a Form 3115 providing for an accounting method change to deal with the revised lives, claiming a significant deduction for amounts that should have been depreciated in prior years and claiming increased depreciation for the years now before the Court.

Generally §1060(a) provides:

(a) General rule

In the case of any applicable asset acquisition, for purposes of determining both--

(1) the transferee's basis in such assets, and

(2) the gain or loss of the transferor with respect to such acquisition,

the consideration received for such assets shall be allocated among such assets acquired in such acquisition in the same manner as amounts are allocated to assets under section 338(b)(5). If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.

Peco argued that it should be able to allocate the building under §338(b)(5), however the Tax Court noted that the final sentence provides an override to the general allocation rules of §338(b)(5) if there is an agreement on the allocation. While the IRC provides only for a challenge to be raised by the Internal Revenue Service, the Tax Court recognized that a taxpayer can raise a challenge only if able to show the agreement on allocation was unenforceable.

Effectively, the Tax Court did not agree with the implied argument that Peco was making that the listing of undifferentiated "building" assets was, effectively, an allocation to a mixed basket of assets rather than an allocation to a single unitary asset.

The Court found that Peco was attempting to allocate price among assets not listed on the original allocation schedule when the cost segregation study was performed. By doing so, the Court found, Peco was challenging the enforceability of each agreement, essentially arguing the terms used were ambiguous and failed to reflect the parties intention to include special mechanical systems and assets that generally qualify as §1245 property in that grouping.

In the first case, the Court found the inclusion of the word "building" in the processing plant building description was significant, rather than simply allocating to the "plant." The Court found that the more specific term limited the applicability of the allocation to the actual building, showing an intent to limit the allocation to the structure and not the assets contained in that building. The Court went on to note that the agreement also allocated a portion of the proceeds to "machinery, equipment and furniture" to indicate that the parties had been aware of other assets and had specifically chosen how much to allocate there.

In the second agreement, with the label "real property improvements" the Court also found no ambiguity in the agreement. As with the first agreement, in this case the parties had allocated a portion of the price to machinery, equipment, furniture and fixtures, showing they were aware of the existence of assets in addition to the building.

The Court notes that if Peco were now allowed to treat a portion of the amounts allocated to the real estate as §1245 assets, the IRS could be whipsawed by an inconsistent (and likely) treatment by the seller of the entire proceeds as related to a §1250 asset. As well, binding Peco to the original allocation also insured that Peco did not end up with a better tax result than it had bargained for. The Court noted specifically that Peco undertook this division only after being informed of the result in *Hospital Corporation of America v. Commissioner*, 109 T.C. 21 (1997) by their accounting firm which it used as evidence that the entity was now seeking a "sweeter" deal.

While cost segregation studies are effective in many cases, in this case the overriding nature of §1060(a)'s binding allocation rules may get in the way of further subdividing an asset. The result in this case suggests that any such work to "break down" an acquired asset needs to be part of the negotiations with the seller to set the allocation, rather than work done after the fact.

On appeal the Eleventh Circuit (Docket No. 12-12169, 7/5/13, http://www.ca11.uscourts.gov/unpub/ops/201212169.pdf) in an unpublished opinion affirmed the Tax Court's holding.

Section: 1239
Restrictions Imposed on Majority Owner Not Significant Enough to Render Him Not a Related Party

Citation: Fish v. Commissioner, T.C. Memo. 2013-270, 11/26/13

In the case of Fish v. Commissioner, T.C. Memo. 2013-270, (http://www.ustaxcourt.gov/InOpHistoric/FishMemo.Paris.TCM.WPD.pdf) the IRS was asserting that IRC §1239 served to require treatment of a payment the taxpayer treated as a capital gain as ordinary income.

The payment arose from a transaction where a taxpayer brought in a private investor to purchase part of his network security solutions company. While the details are a bit involved, effectively Mr. Fish ended up receiving cash form the transaction in which he effectively sold an interest in his S corporation.

The structure of the transaction was such that the transaction resulted in step-up of the corporation's assets, primarily resulting in the recognition of $9.6 million of §197 intangible assets. This sale passed through the S corporation to Mr. Fish on his K-1, and was categorized as a capital gain.

IRC §1239 generally provides that if a taxpayer directly or indirectly sells appreciated depreciable (or §197 amortizable) assets to a related party, the resulting gain recognized must be considered ordinary income. This prevents the taxpayer from being to gain ordinary deductions for depreciation after triggering income at the lower capital gain rates.

Mr. Fish technically retained a majority interest in the surviving entity and was its CEO, but argued that various restrictions imposed by the third party investor group rendered his interest a "less than 50%" interest. For instance, Mr. Fish could not unilaterally amend the corporate bylaws or articles of the company, limited the ability to issue dividends, issue any stock, trigger a liquidation event, acquire or dispose of a material amount of assets, change the nature of the company's business, or hire any employee with a salary above $150,000. In each of those cases, Mr. Fish had to obtain consent from the investor group.

Mr. Fish had the right to select two members of the board of directors, as did the investor group. Mr. Fisher also had the right to select the "tie breaking" director, but that director had to be an independent party. The investor group had to approve that directory, but could not unreasonably withhold its consent.

Mr. Fish argued that these various restrictions served to render his interest not a greater than 50% interest in the corporation. If that was the case, Mr. Fish would not be a related party.

However, the Tax Court did not agree that these restrictions served to reduce Mr. Fish's interest below the 50% level. While agreeing the restrictions were real, the Court found none of them represented such a major restriction on Mr. Fish's activities to deny him majority owner status for tax purposes.

The Court considered Mr. Fish's continued role in the management of the company and the fact that the retention of Mr. Fish's services was a major issue in the purchase of the company to support the belief that he retained effective majority control in line with his nominal greater than 50% interest.

Section: 1402
LLC Members Who Took Salary from Partnership Still Subject to Self-Employment Tax on All Trade or Business Income Flowing Out from the Partnership

Citation: Chief Counsel Advice 201436049, 9/5/14

The IRS National Office has given additional insight in how it views the implications of the case of *Renkeymeyer, Campbell & Weaver, LLP,* 136 T.C. 137 (2011) on self-employment tax obligation of LLC members.

In Chief Counsel Advice 201436049 the IRS looks at an LLC that paid members a salary they claimed represented "reasonable compensation" and then treated the members' share of partnership income from its trade or business (in this case, fees paid for providing management services for a series of investment partnerships) as income received by a limited partner exempt from tax under IRC §1402(a)(13).

The taxation of partnership income for self-employment income purposes is governed generally by the beginning of IRC §1402(a) which provides in pertinent part:

> (a) Net earnings from self-employment
>
> The term "net earnings from self-employment" means … his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member;

Of note is the fact that, unlike for a sole proprietor, a partner may not him/herself be involved in the trade or business, as the "carried on" test is applied to the partnership and not the individual partners. So the general rule is that all partners pay self-employment tax on partnership income. Please note, as well, that nowhere in that definition is the term "general partner" used, a fact that may be surprising to some practitioners.

IRC §1402(a) then goes on to list a number of "exceptions" to the general rules for various classes of income, such as the one for rental of real estate found at IRC §1402(a)(1) and, of more import for the issue considered in this case, the limited partner exception found at IRC §1402(a)(13).

That exception provides:

> (13) there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services;

At the time this provision was added to the law there were no LLC statutes on the books—and the question of how to treat LLC members and those of closely related variants like LLP members for these purposes has been a controversy from the very beginning of LLCs in the first Wyoming statute.

LLC members are "like" limited partners in the sense that their liability is limited by statute. But they are unlike limited partners in the sense that their participation in the management of the entity does not remove their limited liability.

In the *Renkemeyer* case, the Tax Court found that LLP members of a law firm were not to be treated as limited partners merely because they had limited liability due the entity's LLP status. Rather, as their legal services generated virtually all of the income of the entity, the court found that the real test was their participation.

The court based this view on the observation that IRC §1402(a)(13) enactment, per the legislative history, was meant to exclude from self-employment coverage the income of "mere investors" in a partnership.

Unlike the attorneys in *Renkemeyer,* the partners in this case were paid a salary from which payroll taxes were withheld. The partnership argued that so long as that salary represented reasonable compensation for the members' services, the LLC members should be treated as limited partners for purposes of the self-employment tax.

The memorandum disagreed with this conclusion. The memo quotes heavily from a 2012 New Mexico U.S. District Court case (*Riether v. United States*, 919 F.Supp.2d 1140 (D. N.M. 2012)).

That court, considering another case where partners received a salary and then treated the partnership income as that of a "limited partner," noted in its ruling:

> The magic words "unearned income" won't do the trick. The Revenue Code says the self-employment tax applies to a taxpayer's distributive share of partnership income. I.R.C. § 1402(a). Only one relevant exception exists, and it applies to limited partners.... For a taxpayer treated as a general partner, however, the distributive share of partnership income is subject to self-employment tax "irrespective of the nature of his membership." Treas. Reg. § 1.1402(a)–2(g). See also *Ding v. Comm'r*, 74 T.C.M. (CCH) 708 at *2 (1997) (noting that partnership earnings other than those received by a limited partner generally constitute self-employment income). Plaintiffs are not members of a limited partnership, nor do they resemble limited partners, which are those who "lack management powers but enjoy immunity from liability for debts of the partnership." *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*, 136 T.C. 137, 147 (2011). Thus, whether Plaintiffs were active or passive in the production of the LLC's earnings, those earnings were self-employment income. Summary judgment is appropriate on this issue.

The memo then goes on to consider the application to this case. The memo takes the position the New Mexico court did that if the earnings came from a trade or business that consisted of the services of the partners, the entire amount flowing through represents self-employment income. The memo holds this is true even though "even though Partners paid more than a nominal amount for their Units." This seems to take the position that the discussion of "little capital being invested" at the end of the *Renkemeyer* opinion is not a relevant consideration if the income is actually generated by services (or maybe even if it is not—the memo doesn't really deal with that issue.).

As well, the memo concludes with a statement that the entity "is not a corporation and the 'reasonable compensation' rules applicable to corporations do not apply."

Advisers should note that this is just an internal memorandum of the IRS, but it may signal a more aggressive and hard-line IRS position on self-employment income treatment of LLC members. Certainly it would be prudent to discuss the potential implications of a more hard-line IRS position with clients who are taking positions that a portion of their LLC trade or business earnings are not subject to self-employment tax.

Section: 1441
IRS Can Notify Withholding Agent It Can No Longer Rely on W-8ECI if Foreign Taxpayer Fails to File U.S. Tax Return

Citation: Chief Counsel Advice 201428007, 7/11/14

In Chief Counsel Advice 201428007, http://www.irs.gov/pub/irs-wd/201428007.pdf, the IRS Chief Counsel's office advised that the IRS may notify a withholding agent that a beneficial owner's claim of exemption from withholding for effectively connected income is in error due to the failure of that owner to file a U.S. income tax return.

Generally, as the memo notes, IRC §§1441 and 1442 require a withholding agent to withhold 30 percent any U.S. fixed or determinable, annual or periodic income made to a foreign person subject to withholding. However, IRC §1441(c)(1) provides an exception to mandatory withholding for any item of income effectively connected with the conduct of a U.S. trade or business which is included by the owner in gross income under §871(b)(2).

Generally a withholding agent may rely upon a claim of exemption unless the withholding agent has reason to know that the claim is invalid. [Reg. §1.1441-4(a)(2)] As well, if the agent receives notification from the IRS that the claim of exemption is invalid, the agent must begin withholding within 30 days after receiving the notice. [Reg. §1.1441-7(b)(1)]

The memo concludes that since the foreign taxpayer (referred to as the "beneficial owner, or BO, in the memo) had signed a Form W-8ECI that contains language indicating that the BO must file an annual U.S. tax return to claim this status, the IRS, having established that such returns are not being filed, has evidence the claim of exemption is invalid and can notify the withholding agent.

The agent then has 30 days from receipt of that notice to begin withholding. If the agent fails to do so, it may be subject to liability for any tax due under IRC §1461.

If the foreign taxpayer eventually does file a tax return for a year when tax is withheld, it will be able to claim credit for the tax withheld.

Section: 1471
IRS Provides Guidance in FAQ on Website for Use of Substitute W-8 Series Forms to Meet FACTA Requirements

Citation: FACTA General Provisions Frequently Asked Questions from irs.gov, 9/25/14

The IRS has issued a revised portion (in Question 8) of the FACTA General Provisions Frequently Asked Questions (FAQ) that discusses the use of a Substitute Form W-8 withholding certificate to comply with the FACTA requirements.

The FAQ provides that a substitute Form W-8BEN, W-8BEN-E, W-8ECI, W-8EXP, or W-8IMY whose content is substantially similar to the IRS forms may be used where the partner jurisdiction does not decline such treatment.

The FAQ provides:

- A payor may develop and use a substitute form that is in a foreign language, provided that you make an English translation of the form and its contents available to the IRS upon request.
- A payor may combine Forms W-8BEN, W-8BEN-E, W-8ECI, W-8EXP, and W-8IMY into a single substitute form.
- A payor may provide a substitute form that does not include all of the chapter 4 statuses provided on the Form W-8, but the substitute form must include any chapter 4 status for which withholding may apply, such as the categories for a nonparticipating FFI or passive NFFE.
- A payor may provide with the form an alternative certification that reflects the requirements under an applicable intergovernmental agreement (IGA) instead of the certification of chapter 4 status otherwise required by the form.

The payor must provide instructions similar to those in the official form along with its substitute form. As well, the payor can incorporate the substitute W-8 into other business forms so long as the required certifications are clearly set forth.

Nevertheless, the payor may not:

- Use a substitute form that requires the payee, by signing, to agree to provisions unrelated to the required certifications, or

- Imply that a person may be subject to 30% withholding or backup withholding unless that person agrees to provisions on the substitute form that are unrelated to the required certifications.

The document must still provide that the data provided in the W-8 substitute area is being provided under penalties of perjury.

Substitute forms may also be used in place of W8-BEN, subject to similar conditions.

Section: 1502
Entire Consolidated Group Taken as a Whole Is Tested, Rather Than Each Member of the Group, for Application of Personal Service Corporation Tax Rates

Citation: Applied Research Associates and Affiliate v. Commissioner, 143 TC No. 17, 10/9/14

The interplay between the consolidated corporation rules found in IRC §1502 and the provisions of §11(b)(2) that deny the benefit of the lower corporate tax brackets to personal service corporations (PSC) as defined in §448(d)(2) were at issue in the case of *Applied Research Associates and Affiliate v. Commissioner*, 143 TC No. 17.

The affiliated group in this case consisted of a corporation that performed engineering services (which met the definition of a personal service corporation) and corporation that owned a cattle ranch (clearly a corporation that would not meet the test). The IRS and taxpayer also agreed that if the combined operation was tested as one corporation, it would not meet the definition of a personal service corporation.

In the year in question the engineering corporation showed net income while the cattle operation ran at a loss.

The IRS argued that the test for whether a corporation is a personal service corporation applies separately to each member of an affiliated group. The IRS noted that IRC §448(d)(4) contains provisions specifically outlining how each member of an affiliated group is to be tested separately as a personal service corporation to determine eligibility for the cash method of accounting. The IRS argues that this "separate treatment" test carries over to the provisions of IRC §11(b)(2) to require a "carve out" of the affiliate(s) that are personal service corporation, taxing their income at the flat 35% rate separate and apart from the other entity(ies).

The Tax Court disagreed. It noted that §448(d)(4) only discussed separate testing in the context of qualifying for the cash basis. The court also noted that the IRS's own regulations under §1502 fail to discuss the issue of the application of the §11(b)(2) denial of lower brackets in the context of a consolidated group. Rather the regulations provide a general rule that the income and losses of the members of the group are to be combined and tax paid on the combined income. While Reg. §1.1502-2 provides of list of separately calculated taxes in Reg. §1.1502-2(b)-(j), the Court notes that Reg. §1.1502-2(a) specifically includes a personal service corporation's income in consolidated.

The court concludes that, given the IRS has not modified the regulation for this issue despite the PSC rules being in place since 1987, the proper test for PSC status is to be applied at the consolidated group level in this case. As such, the entire income of the consolidated group can qualify for application of the lower tax brackets.

The Court recognizes that Congress's intent in enacting the PSC rules could be circumvented by entities filing consolidated returns with non-PSC organizations, the Court effectively finds that if the IRS is troubled by that result it's up to the IRS to modify the regulations under §1502 to provide for a separate calculation in such a case. The Court declines to, effectively, write its own set of special additional rules when the IRS has failed to do so for over 25 years.

Section: 1504
Corporation Included Subsidiary in Consolidated Group Prematurely, Since Parent Did Not Have Right to Vote Stock

Citation: CCA 201414015 and CCA 201433013, 4/4/14 and 8/15/14

In Chief Counsel Advice 201414015 (http://www.irs.gov/pub//irs-wd/1414ced015.pdf) the IRS concluded that a corporation had included a new subsidiary prematurely in its consolidated tax return.

In the case in question the taxpayer had agreed to acquire 100% of the stock of a corporation over the course of several purchases. In the first year the parent acquired less than 80% of the stock. The agreement provided that the seller would put all remaining shares into an escrow account, to be released when the buyer at the time the shares were purchased.

Under the agreement, the buyer could acquire shares during the first quarter of year 2 for a price set on the value of the selling corporation immediately before the beginning of year 2. The taxpayer bought shares at that price (which pushed the buyer over the 80% threshold). Both the buyer and seller recorded the sale as taking place on the first day of year 2 and reported the transaction that way in their GAAP financial statements.

The escrow agent delivered the shares to the buyer upon payment, which took place in the first quarter (but not on the first day) of year 2.

The buyer then included the new subsidiary in its consolidated return as of the first day of year 2, and did not file any short year return for the subsidiary since it had acquired it as of the first day of both company's tax years.

The taxpayer argued that it was under an unconditional obligation to acquire shares sufficient to push it over 80% at a price fixed immediately before the beginning of the tax year. Thus the benefits and burdens of ownership had passed even if legal title transfer and actual possession of the shares did not take place until later.

The memorandum did not agree. It noted that the purchase agreement provided that the sellers maintained voting rights and rights to all distributions up until payment was made and the shares released from escrow.

Thus, the ruling notes, the buyer did not have 80% voting control as of the first day of the tax year. Those voting rights (which are required in order to consolidate the subsidiary) did not pass until payment was made.

The ruling held that the case law on the transfer of benefits and burdens cited by the taxpayer was not relevant with regard to the specific technical requirements of IRC §1504.

The taxpayer was not happy with this ruling and submitted additional information and arguments. The National Office responded with CCA 201433013 (http://www.irs.gov/irs-wd/201433013.pdf) where the same position was taken and the taxpayer's objections were addressed.

The taxpayer presented two arguments:

- Once the Buyer had over 50% control, the Buyers effectively divested the Sellers of any useful right to Vote the shares or the right to receive liquidating distributions or dividends, as the Buyer completely controlled the corporation and the entity could not pay a dividend or liquidate unless the Buyer decided it would.
- The prior ruling failed to take into account the true benefits and burdens of ownership, and thus is at odds with earlier rulings in the area of §1504.

On the first issue the IRS cites the cases of *Handy & Harman v. Burnet*, 284 U.S. 136 (1931) and *Ice Service Co. v. Commissioner*, 9 B.T.A. 386 (1927); *affd*., 30 F.2d 230 (2nd Cir. 1929) for the position that practical control of a corporation does not provide affiliation.

As well, the ruling notes that even if the voting power theory was accepted (which the IRS does not accept) it is clear that they did not have 80% of the *value* as of that date, a requirement under §1504(a)(2)(B). The IRS does not accept the view that since the Buyer had to consent to any liquidation or dividend the value had effectively been transferred to the Buyer.

The IRS also did not agree that the Buyers had the benefits and burdens of ownership. The CCA notes that the taxpayer had cited a 2012 Chief Counsel memorandum which provided for the following four tests for "benefits and burdens":

- Which party has the opportunity to share in gain from an appreciation in value of the stock and bears the risk of loss from a decline in value of the same;
- Which party has legal title to, and the ability to dispose of, the stock;
- Which party has the right to vote the stock; and
- Which party has possession of the stock

The cited memo goes on to note that "Courts have also focused upon the right to receive dividends."

In this case only the first factor is resolved in favor of the Buyer, as the purchase price was fixed. The memo notes that the Seller retained legal title on the stock, the Buyer had no ability to dispose of the Seller's stock, the Seller retained the right to vote the stock (albeit, a vote that may not stop anything), an escrow agent had possession of the stock and the Seller retained the right to receive dividends (again, recognizing that the Buyer may very well control whether any such dividends would be paid).

Thus, the memo concludes the same as before—the subsidiary may not be consolidated until the 80% control trigger is passed.

Section: 3101
Special Optional Refund Procedures Outlined for Payroll Tax Matters Affected by the Windsor Decision Striking Down a Portion of the Defense of Marriage Act

Citation: Notice 2013-61, 9/23/13

Special procedures for handling refunds of payroll taxes due to the effects of the Supreme Court's *Windsor* decision are provided by the IRS in Notice 2013-61 (http://www.irs.gov/pub/irs-drop/n-13-61.pdf).

Employers prior to the *Windsor* decision withheld income taxes, social security, Medicare and additional Medicare taxes on certain amounts paid on behalf of an employee's same sex spouse that would have been excludable had federal law recognized the marriage relationship. Such payments include, for instance, medical insurance paid for by the employer for the same sex spouse. Similarly, employers did not exclude amounts withheld from a employee's wages for medical insurance provided to the same sex spouse, even though the employee him/herself had excluded amounts for their own coverage via a §125 cafeteria plan.

Revenue Ruling 2013-17 provided general rules regarding the recognition of same sex marriage status following the U.S. Supreme Court's decision in *United States v. Windsor,* 133 S.Ct. 2675 (2013). Generally the ruling provided that such marriages must be recognized prospectively beginning September 16, 2013, but that taxpayers may apply the ruling retroactively for any years still open.

Employers now may find that they have refund claims available. This notice provides an optional method to correct filings and/or apply for refund claims. One set of options applies to the calendar year 2013, while a single optional method is given for overpayments related to prior years. Employers are not required to use these methods, but rather can use the normal method proscribed for such changes.

Of immediate concern when this notice was published in late September were filings for the third quarter of 2013, filings that would be due on October 31. If an employer had withheld taxes that should not have been withheld in the fourth quarter (likely since Revenue Ruling 2013-17 was not issued until late August), the employer may report the proper amounts of withheld taxes *if* the employer refunds the overpayments to employees before filing the third quarter Form 941. If the employer does not refund such amounts by that date, <u>the overwithheld amounts must be reported on the return</u> and then one of the methods described below will be used to recover the 3rd quarter overpayments (along with those for the 1st and 2nd quarters).

For changes affecting 2013, the ruling provides the taxpayer may optionally elect to either:

- Do a cumulative correction on the fourth quarter Form 941. The notice outlines how to prepare that 941, specifically outlining how to report the correction on the forms that show an employer's deposits. Generally an employer will simply reduce the appropriate amounts on the fourth quarter 941 to remove any amounts effectively over-reported in earlier periods. This method may only be used if all overpayments are returned to the employees before December 31, 2013;
- File a Form 941-X for the fourth quarter to make all corrections. In this case the employer must obtain statements from employees regarding the fact that they have been repaid their overpayments for FICA and Medicare and that they will not seek their own refund from the IRS. The Form 941-X should contain only corrections described in Notice 2013-61—thus, if another error is uncovered, even if known at the time of filing under this procedure, that error must be corrected on a separate Form 941-X (or the employer may simply decide to use the standard procedures). Form 941-X filings under the special rule should have "WINDSOR" written in dark, bold letters across the top margin of Form 941-X (so get out your Sharpees).

As the IRS notes, once a year ends without a repayment of overwithheld income taxes, that amount cannot be claimed as a payroll tax adjustment. Rather, the employee's W-2 will show these taxes as withheld, and the employee will claim the benefit on the Form 1040. A similar rule applies to the additional Medicare taxes withheld in 2013. Thus, those using the second procedure above (but not the first) will not make an adjustment to withheld income taxes if the amounts were not repaid prior to year end.

As a practical matter, this second method may need to be used by some employers if their own payroll reporting systems are unable to produce the modified third and/or fourth quarter 941s where the adjustments are "folded in" to the 941. Most software will require some modification to be able to handle that sort of adjustment and employers may decide the cost of making this one time modification is too high to justify doing so—in that case, the Form 941-X method will be used.

The second optional procedure is used for earlier years. For the years that remain open for claims for refund, the IRS will accept a single Form 941-X for the fourth quarter of the year(s) in question. Again such Form 941-X's should have "WINDSOR" written in dark, bold letters across the top of the form.

The 941-X procedures primarily simplify matters by allowing a single Form 941-X to take care of all adjustments for the year(s) in question, rather than needing a separate Form 941-X for each quarter. Again, conceivably an employer may have software that can produce the "traditional" 941-X and could decide that it will be administratively simpler to use the traditional procedures. The Notice does not mandate the optional procedures, thus such employers can still use the "every quarter" method of modifying Forms 941.

Section: 3121
Counseling Taxpayer that Suboptimal Tax Laws are Still Valid Tax Laws, Court Upholds Imposition of Payroll Taxes on Deferred Compensation Taxpayer Will Never Receive

Citation: Balestra v. United States, 113 AFTR 2d ¶2014-887, 5/31/14

The Court of Federal Claims concluded something all of us learned early on—"suboptimal tax laws are still valid tax laws" in upholding the taxation of deferred compensation in 2004 for a taxpayer that was clear even when included in the employee's income would never be paid in the case of *Balestra v. United States*, 113 AFTR 2d ¶2014-887, https://ecf.cofc.uscourts.gov/cgi-bin/show_public_doc?2009cv0283-87-0.

The taxpayer in this case was a pilot for an airline who retired in 2004. The airline in question entered bankruptcy in 2002. In 2004 Mr. Balestra retired from the airline.

One of the benefits promised to Mr. Balestra was a nonqualified deferred compensation payment arrangement. The benefit vested upon Mr. Balestra's retirement. Under IRC §3121(v)(2) the airline computed the present value of the promised future benefits to be paid under the program. Based on that computation the airline withheld Medicare taxes (Mr. Balestra was over the FICA limit for 2004) on that value.

IRC §3121(v)(2) imposes a special rule for FICA and Medicare taxes imposed on nonqualified deferred compensation arrangements. Under the special timing rule, the tax is imposed on such arrangements at the later of the date services are performed or when there is no substantial forfeiture of rights to the amount.

Under the regulations implementing this provision (Reg. §31.3121(v)(2)-1) that value is computed without regard to the possibility that the payments may not be made due to the fact that the plan is not currently funded, the employer may be unable to pay or there may be a future change in the law. Rather, this is a straight actuarial calculation of present value.

Using that methodology spelled out in the regulations, the airline computed the present value of the taxpayer's benefit as $289,601.18 and withheld 1.45% (or $4,199.22). However, the airline was eventually relieved of the responsibility to pay most of this benefit at the end of its bankruptcy proceeding and Mr. Balestra only actually received $63,032.09 of benefits through 2010, with no additional benefits to be received under the program in the future.

The taxpayer, not surprisingly, felt this was unfair, especially as the airline was already in (and had been in for two years) the bankruptcy proceeding that would lead to the reduction of the benefit when Mr. Balestra retired. It certainly did not take much foresight to conclude Mr. Balestra was highly unlikely to receive $289,601.18 of benefits, whether or not the benefits were to be discounted to present value.

However, the IRS argued that the regulations properly required the payment of the tax on the total benefit. The Court, noting that the question before it was simply whether the IRS's regulation was a reasonable interpretation of the statute found that it was.

The taxpayer argued first that the amount should not be considered taxable until paid. The Court rejected that view, noting that if it adopted that reading of the statute that §3121(v)(2) would be rendered meaningless, since tax would always be imposed at the same time as under the standard timing rules for FICA and Medicare tax obligations. Generally, when comparing alternative interpretations of a statute, the Court will avoid an interpretation that renders the provision irrelevant unless it is clearly required by the unambiguous language of the state.

The Court also noted that the language used by Congress (that the tax is triggered "when there is no substantial risk of forfeiture of the rights to such amount") uses terms given specific meaning by IRC §83(c)(1) and which, by itself, contains no reference to a risk of nonpayment. While that statute was specifically limited to property actually received, Congress included no such restriction in §3121(v)(2).

The taxpayer argued secondly that Congress must have meant to include "standard accrual accounting" and argued that since it was clear there was a significant question with regard to payment of the vast majority of the benefit, the amount taxed should have been reduced that uncertainly. However, the Court refused to effectively "add" to the statute such an implied reference, noting that Congress has explicitly included such references in other statutes but chose not to do so here.

The Court note that, under the standard imposed by the U.S. Supreme Court in the case of *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, a regulation interpreting a ambiguous provision of the statute must be upheld if it is reasonable. The Court found, given its analysis, that the IRS's interpretation was a reasonable one for what might be charitably called a "flawed" statute.

The Court took a dig at Congress by noting, after considering alternatives that Congress arguably should have used:

> But these are matters for law makers, not judges—suboptimal tax laws are still valid tax laws. (Title 26 of the United States Code would be a good deal shorter if the unwise tax laws could be purged by the judiciary.)

So, at the end of the day, the Court found the IRS properly applied an unwise, suboptimal law in a reasonable fashion. And so, the taxpayer was not eligible for a refund of Medicare taxes imposed on a benefit he will never receive.

Section: 3121
RSU Dividends Are Not Deferred Compensation, But Rather a Separate Employee Benefit

Citation: Chief Counsel Email 201414018, 4/4/14

A dividend equivalent unit program associated with restricted stock units (RSUs) is a separate employee benefit and are not deferred compensation, per the conclusion in Chief Counsel Email 201414018 (http://www.irs.gov/pub/irs-wd/1414018.pdf). The issue in question involved their treatment for FICA purposes.

Generally the present value of deferred compensation is subject to FICA tax when the rights are vested, rather than being taxable when paid. Due to the existence of the cap on earnings subject to FICA each year and the discounting for present value calculation, it is likely the taxpayer wanted this treated as part of the deferred compensation arrangement.

The memorandum find that RSUs, not being actual stock, are entitled to dividends in and of themselves. As well, the dividends are not required to be paid, but are paid at the discretion of the employer, a privately held company. Under Reg. Sec. 31.3121(v)(2)-1(b)(3)(i) an employee does not have a legally binding right to compensation if the employer can reduce or eliminate the item unilaterally.

The email notes that this may be distinguished from a plan where the account balance is increased by the total return on a specific publicly-traded common stock. The difference is that the latter is out of the employer's control.

So in this case the RSU dividends will be subject to FICA tax when paid.

Section: 3121
Supreme Court Rules Severance Payments Are Subject to FICA Taxes

Citation: United States v. Quality Stores, Supreme Court Docket No. 12-1408, 2014 TNT 58-16 reversing CA6 2012-2 U.S.T.C. ¶50,551, 3/25/14

The U.S. Supreme Court resolved a split among lower courts regarding whether severance payments under a severance plan are subject to FICA, overruling the holding of the Sixth Circuit Court of Appeals in the case of *United States v. Quality Stores*, http://www.supremecourt.gov/opinions/13pdf/12-1408_6468.pdf, Docket No. 12-1408, 2014 TNT 58-16.

The District Court for the Western District of Michigan in *United States v. Quality Stores* weighed in the question of whether severance payments made under a severance plan are subject to FICA taxes, disagreeing with the conclusion of the Federal Circuit Court of Appeals in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008). The Michigan court concluded that the payments are not subject to FICA, being properly treated as supplemental unemployment compensation benefits ("SUB" pay).

The IRS position, stated in Revenue Ruling 90-72, is that such a program only qualifies for an exemption the pay must be linked to the receipt of state unemployment benefits and not paid in a lump sum. However, the Michigan District Court, sustaining the prior holding of the Bankruptcy Court that was appealed to it, found that while IRC had the authority under §3121(a) to issue regulations treating such a payment as wages, the IRS had not done so, but rather simply issued the Revenue Ruling.

Given that no regulations had been written, the Court felt the wording of §3402(o) that said such payments shall be treated as "if they were wages" for purposes of income tax withholding implied that they were not otherwise wages—and thus not subject to FICA. Thus the Court held that the Bankruptcy Court had properly decided that Quality Stores was due a refund of FICA taxes paid on the payments.

The Sixth Circuit Court of Appeals sustained the position of both lower courts when the IRS appealed the case before it, refusing to accept the IRS's ruling as the final word on the law. The appellate court did note that the matter likely would need to be decided by the U.S. Supreme Court given the split in the Circuits.

It turns out that the Sixth Circuit's crystal ball was clear on this issue, since the U.S. Supreme Court granted the government's petition for certiorari on October 1, 2013 and in March of 2014 overturned the Sixth Circuit's ruling in an 8-0 unanimous ruling (Justice Kagan, who was involved in the matter previously in her former position as U.S. Solicitor General, did not take part in this decision).

The Supreme Court refused to take the view, noted above, that IRC §3402(o) effectively meant that severance payments generally were not wages, and that the provision only "pretended" they were wages for income tax purposes. The Court implicitly criticizes the Sixth Circuit's analysis, noting that the Court relied upon an income tax withholding provision rather than looking the specific (and broad) specific definition of wages for FICA purposes in the Code.

The Courts notes that merely stating an amount shall be treated "as if" the amount were wages (the wording of IRC §3402(o)) does not mean the item would not be wages if the provision were not there. The Court goes on to note that IRC §3402(a) was enacted to deal with a specific problem dealing with supplemental unemployment benefits negotiated by various unions in specific industries to provide the equivalent of a guaranteed wage.

Some states' unemployment programs provided that no payment would be made to any person receiving wages from an employer—so the IRS took the position that such "SUB" payments were not wages for FICA purposes. While solving this problem, it also meant the employees ended up substantially underwithheld at year end, so Congress enacted §3402(o) to allow for wage withholding from these "not wages" to solve that program.

The Supreme Court noted:

> Once this background is understood, the Court of Appeals' interpretation of § 3402(o) as standing for some broad definitional principle is shown to be incorrect. Although Congress need not have agreed with the Revenue Rulings to enact § 3402(o), its purpose to eliminate the withholding problem caused by the differential treatment of severance payments is the necessary background to understand the meaning and purpose of the provision. The problem Congress sought to resolve was the prospect that terminated employees would owe large payments in taxes at the end of the year as a result of the IRS' exemption of certain SUBs from withholding. It remained possible that the IRS would determine that other forms of SUB plans, perhaps linked differently to state unemployment benefits, should be exempt from withholding. If Congress had only incorporated the Revenue Rulings already in effect, that response may have risked the withholding problem arising once again. On the other hand, by drawing a withholding requirement that was broader than then-current IRS exemptions, Congress avoided these practical problems. A requirement that a form of remuneration already included as wages be treated "as if " it were wages created no administrative difficulties.

So at this point we now have a resolution to the issue of FICA taxation of such severance programs—they are subject to the tax.

Section: 3301
DOL Releases List of States That Face Reduction of FUTA Credit for 2014

Citation: Department of Labor Website, 11/10/14

The Department of Labor has released the list of states which have not repaid their federal UI loans by November 10, 2014 and which, therefore, will face a reduced FUTA credit on Form 940 for 2014.

Employers in those states will incur a FUTA liability of 0.6% plus the credit reduction.

The final table is reproduced below:

State	Final 2014 FUTA Credit Reduction	Repaid Outstanding Title XII Advance-2014	2014 BCR add-on	Eligible for BCR Add-on Waiver	Eligible for Avoidance	Final 2014 FUTA Tax Rate
Alabama						0.6%
Alaska						0.6%
Arizona						0.6%
Arkansas		X				0.6%
California	1.2%			X		1.8%
Colorado						0.6%
Connecticut	1.7%		0.5%			2.3%
Delaware		X				0.6%
District of Columbia						0.6%
Florida						0.6%
Georgia		X				0.6%
Hawaii						0.6%
Idaho						0.6%
Illinois						0.6%
Indiana	1.5%			X		2.1%
Iowa						0.6%
Kansas						0.6%
Kentucky	1.2%			X		1.8%
Louisiana						0.6%
Maine						0.6%
Maryland						0.6%
Massachusetts						0.6%
Michigan						0.6%
Minnesota						0.6%
Mississippi						0.6%
Missouri		X		X		0.6%
Montana						0.6%
Nebraska						0.6%

State	Final 2014 FUTA Credit Reduction	Repaid Outstanding Title XII Advance-2014	2014 BCR add-on	Eligible for BCR Add-on Waiver	Eligible for Avoidance	Final 2014 FUTA Tax Rate
Nevada						0.6%
New Hampshire						0.6%
New Jersey		X				0.6%
New Mexico						0.6%
New York	1.2%			X		1.8%
North Carolina	1.2%			X		1.8%
North Dakota						0.6%
Ohio	1.2%			X		1.8%
Oklahoma						0.6%
Oregon						0.6%
Pennsylvania						0.6%
Puerto Rico						0.6%
Rhode Island		X		X		0.6%
South Carolina				X	X	0.6%
South Dakota						0.6%
Tennessee						0.6%
Texas						0.6%
Utah						0.6%
Vermont						0.6%
Virginia						0.6%
Virgin Islands	1.2%			X		1.8%
Washington						0.6%
West Virginia						0.6%
Wisconsin		X		X		0.6%
Wyoming						0.6%

Section: 3401
Common Law Employers Referenced for FICA and FUTA Limit, Not Total Paid by Payroll Service Company

Citation: Cencast Services, LLP v. United States, 2013-2 U.S.T.C. ¶50,511, 9/10/13, cert denied 6/23/14

Payroll service companies exist that effectively "outsource" the payroll and human resource issues for organizations. Such organizations take care of paying the payroll and handling such other tasks, but the actual hiring and control remain with the organization engaging the payroll service company.

In such cases, payroll tax case law developed that treats the payroll service company as the "statutory employer" but the client of the service company as the "common law employer" for these purposes. As well, it has been held that the payroll service company, even though not the common law employer, still has the responsibility to withhold and pay over the payroll taxes.

In the case of Cencast Services, LLP v. United States, 2013-2 U.S.T.C. ¶50,511, http://www.cafc.uscourts.gov/images/stories/opinions-orders/12-5142.Opinion.9-6-2013.1.PDF, the question arose regarding the FICA and FUTA liability should the same persons be hired by multiple clients of the payroll service company during the calendar year. Since both taxes are capped at fixed dollar amounts for their applicability, if the employee's wages exceed the cap there arises the key issue of whether the payroll service company can count all payments it made it in determining the cap, or whether it must instead use a separate cap for each common law employer the particular individual worked for during the year.

Not surprisingly Cencast Services (the payroll service company in this case) argued that it should be able to aggregate all wages it pays during the year in computing the caps and had, in fact, been preparing its payroll reports using that system. The matter is significant since Cencast services small motion picture and television production companies and workers often have many different common law employers in the same year.

The IRS did not agree with this view. In TAM 9918056 (http://www.irs.gov/pub/irs-wd/9918056.pdf) the government took the position that the limits must be calculated on a per-common law employer basis. The Court of Claims agreed with this position and Cencast appealed to the Federal Circuit Court of Appeals.

The Appeals Court sustained the Court of Claim's ruling. The Court found the law and regulations apply to the common law employment relationship, and found no evidence Congress intended that an employer could reduce his/her liability for either FUTA or FICA tax by using a payroll service company rather than administering the payroll itself.

Cencast attempted to get the United States Supreme Court to step in and hear the case following the Federal Circuit decision, but on June 23, 2014 the Court decided against hearing Cencast's appeal of this decision.

Section: 3402
IRS Issues Regulations Allowing IRS to Provide for Voluntary Withholding Arrangements

Citation: TD 9692, 9/15/14

The IRS has issue skeletal final regulations enabling the IRS to expand payments eligible for voluntary federal tax withholding in TD 9692.

Under IRC §3402(p)(3) the IRS is authorized to issue regulations allowing for withholding from any payment to which it finds withholding would be appropriate if both the party making the payment and the party receiving the payment agree to the withholding.

The regulation [Reg. § 31.3402(p)-1(c)] allow the IRS to publish voluntary withholding guidance in the Internal Revenue Bulletin, setting forth information on the form and duration of such voluntary payments.

Section: 3502
IRS Memo Describes Risks to Employers if Agent, PEO or Employee Leasing Organization Files 941s Not Compliant With Applicable Rules

Citation: CCA 201438021, 9/19/14

In Chief Counsel Advice 201438021 the IRS looked at the issue of whether or not the statute of limitations begins in various situations where an employer has its payroll tax returns filed by a third party organization, either under a formal designated agreement pursuant to §3502 or via various arrangements other than the

§3502 designated agent arrangement, but of a type recognized by the IRS such as a professional employer organization (PEO) or an employee leasing arrangement.

The memo concludes that the criteria established in the case of *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), aff'd per curiam, 793 F.2d 139 (6th Cir. 1986) outlines the general criterial for a return to be considered to start the statute. The memo summarizes those criteria as:

- Sufficient data be supplied to calculate tax liability;
- The document purport to be a return;
- There be an honest and reasonable attempt to satisfy the requirements of the tax law; and
- The return be executed under penalties of perjury

The memo considers the impact of certain failures of the third party organization or the taxpayer to follow the procedures outlined by the IRS. The memo begins by discussing the general rules for what constitutes a valid return for purposes of starting the running of the statute of limitations.

We will consider each of the scenarios in turn.

The facts for the first scenario are as follows:

> A third party has an approved Form 2678 from the Service authorizing it to act as an agent on behalf of an employer. In accordance with the instructions for Form 941 and Revenue Procedure 2013-39, the agent files an aggregate Form 941 on behalf of the employer (as well as the other employers for whom it has an approved Form 2678) using its own EIN and attaches Schedule R (Form 941), Allocation Schedule for Aggregate Form 941 Filers. On the Schedule R, the agent lists the name and EIN of each individual employer and allocates the amounts of wages, taxes, and payments reported on the aggregate Form 941 to each individual employer for whom it is authorized to file.

In this case the agent has complied with all of the requirements under the regulation. Not surprisingly the memo concludes:

> In Scenario (1), likely all four of the Beard requirements are satisfied: the document purports to be a return, is signed, evinces an honest and reasonable attempt to satisfy the requirements of the law, and provides the Service with sufficient information to compute the agent's and the employer's employment tax liability for whom the agent is authorized to act. Although the employer did not itself file a return, an agent duly authorized by the Service to act for the employer filed an employment tax return on behalf of the employer. Treas. Reg. 31.3504-1; Rev. Proc. 2013-39. Further, because the agent attaches Schedule R to the aggregate Form 941, allocating wages and taxes reported on the return to its employer-clients, the Service has specific payroll and employment-tax information for each individual employer, and thus has sufficient information to determine the agent's, as well as the individual employer's employment tax liability. In essence, the Service receives the same information on the Schedule R as it would have received if the individual employer had filed its own Form 941. Thus, it is as if the employer itself filed the return. Therefore, in Scenario (1), the section 6501 period of limitations commences with respect to the employer when the agent files the aggregate Form 941 with the Schedule R attached.

In the second criteria the agent files a Form 941, but omits the schedule. Here is the exact IRS recitation of the facts:

> A third party has an approved Form 2678 from the Service authorizing it to act as an agent on behalf of an employer. In accordance with the instructions for Form 941 and Revenue Procedure 2013-39, the agent files an aggregate Form 941 on behalf of the employer (as well as the other employers for

> whom it has an approved Form 2678) using its own EIN. However, the agent does not attach Schedule R to the aggregate Form 941 allocating the amounts of wages, taxes, and payments reported on the aggregate Form 941 to each individual employer for whom it is authorized to file as required by the instructions for Form 941 and Revenue Procedure 2013-39.

Although the return was filed, the IRS concludes that they can challenge this one and, by extension, keep the statute for assessment effectively open forever. The memo (with portions redacted) states:

> Unlike Scenario (1), the Service could argue under the facts in Scenario (2) that the agent's filing of an aggregate Form 941 without the Schedule R attached is an insufficient filing to commence the period of limitations on assessment against the employer for whom the agent is authorized to act because it fails to satisfy the first Beard requirement. That is, the return fails to provide sufficient information from which the Service could assess the employment tax liability against the individual employer. Absent the Schedule R (or some form of equivalent information), the Service cannot ascertain from the aggregate Form 941 whether the agent is merely filing the return to satisfy the agent's employment tax filing requirements (as the agent itself may have employees) or whether the agent is filing the Form 941 to satisfy the employment tax filing obligations of each individual employer for whom the agent is authorized to act. See Rev. Proc. 2013-39, § 4.01 (the agent files one return for each tax-return period to report "the wages and employment taxes on the wages paid to its employees, and the wages and employment taxes on the wages paid by the agent to the employees of each employer for whom the agent is authorized to act."). This is important because the employer remains liable for filing all employment tax returns. Id. at §§ 2.02 and 3.05. Further, absent the Schedule R (or some form of equivalent information), the Service cannot ascertain from the aggregate Form 941 which portion of the wages and employment taxes reported on the return are properly attributable to each individual employer. Id. at § 4.03. This is important because the employers for whom the agent is authorized to act are not liable for the aggregate amount reported on the Form 941 by the agent, but remain liable for their own portion of the employment taxes.
>
> **** Portion redacted**** In sum, the Service could successfully argue that the assessment period of limitations under section 6501 is not triggered with respect to the individual employer under the facts presented in Scenario (2). ****Portion redacted ****

The third scenario looks at the issue with a third party payor (not an agent) without a Form 2678 on file which also fails to attach Schedule R:

> A third-party payor (for example, a professional employer organization (PEO)) without an approved Form 2678 from the Service files an aggregate Form 941 on behalf of an employer-client (as well as several other employer-clients) using its own EIN. The third-party payor does not attach Schedule R to the aggregate Form 941 allocating the amounts of wages, taxes, and payments reported on the aggregate Form 941 to each individual employer-client. In accordance with Treasury regulation section 31.3504-2, the Service designates the third-party payor to perform the acts required of each employer-client with respect to wages or compensation paid by the third-party payor to individuals performing services for each employer-client pursuant to a service agreement (as defined by regulation section 31.3504-2) between the third-party payor and each employer-client. The employer-client does not file a Form 941 using its own EIN.

Again the IRS concludes the statute does not start running with this filing. The memo notes:

> In Scenario (3), the Service could potentially argue that the third-party payor's filing of an aggregate Form 941 without the Schedule R is an insufficient filing to commence the period of limitations on assessment against the employer. Like Scenario (2), the third-party payor's filing fails to satisfy the

> first Beard requirement -- that is, it fails to provide sufficient information to allow the Service to compute the individual employer's employment tax liability.
>
> For the reasons discussed above with respect to Scenario (2), the third-party payor's filing of an aggregate Form 941 does not provide the Service with sufficient information to compute the individual employer's employment tax liability. See Form 2678 Agent Filing Aggregate Form 941 Without Schedule R, supra. Moreover, in Scenario (3), although there is no specific requirement in published guidance or the form instructions for the third-party payor to file a Schedule R, there is also no authorization for the third-party payor to file an aggregate Form 941 under the payor's EIN on behalf of multiple employers in the first instance. Generally, employers are required to file individual employment tax returns and have no authority to file an aggregate return unless they have an approved Form 2678 from the Service. See Rev. Proc. 2013-39 and Instructions for Form 941. Moreover, the Service has even less information with respect to the individual employer than it does under the facts described in Scenario (2), because the Service will not have the Forms 2678 on file to inform the Service that an agent is appointed to perform the acts required of the employer.
>
> ****Paragraph redacted****

In this case the IRS is looking at various third party arrangements, which would include PEOs and employee leasing operations. And, clearly, the memo concludes that if the third party merely tries to file a single Form 941 for its clients the IRS can take the position that it has no real time limit on examining any of the entity's clients for payroll tax issues, as no returns have (in the view of the IRS) been filed.

Finally, the IRS looks at the case of a third party payor that also is missing a service agreement that complies with Reg. §31.3504-2. The facts there are:

> A third-party payor (for example a PEO) without an approved Form 2678 from the Service files a Form 941 using its own EIN, which purportedly includes wages or compensation that it paid for an employer-client to individuals performing services for the employer-client. The third-party payor and the employer-client did not enter into a service agreement (as defined by regulation section 31.3504-2). Thus, the Service does not designate the third-party payor to perform acts required of each employer under section 31.3504-2 with respect to the employer-client. The employer-client does not file a Form 941 using its own EIN

Not surprisingly the IRS again concludes the statute remains open for all of the payor's clients. The memo states:

> Under the facts described in Scenario (4), the return filed by the third-party payor is an insufficient filing to commence the period of limitations on assessment against the employer. Nothing in the Code or the regulations authorizes the third-party payor to file a return on behalf of the employer, and employment tax obligations cannot be altered by private agreements between an employer and a third-party payor. See *Professional Security Services*, supra. Moreover, in this scenario, unlike Scenarios (1), (2), and (3), nothing in the Code or regulations makes the third-party payor liable to pay the employment tax, i.e., the third-party payor is not the taxpayer (or a co-taxpayer) because the payor is not the employer , an agent with an approved Form 2678, or a payor designated to perform the acts required of an employer. The facts in Scenario (4) are not materially distinguishable from a situation in which a third-party that is not authorized to act for the taxpayer under the Code or regulations signs the taxpayer's return; in such cases, courts have held that the return signed by an unauthorized person is invalid. See, e.g., *Weiner*, 255 F. Supp.2d at 647-48 ("the taxpayer must execute the return under penalties of perjury. . . . Weiner's arguments overlook the fourth element of the *Beard* test. Since Voyer was not a partner, he was not an authorized signatory for the 'taxpayer.'"

> (emphasis in the original)); *Elliott v. Commissioner*, 113 T.C. 125, 128– 29 (1999) (individual income-tax return signed by the taxpayer's attorney did not satisfy the signature requirements of the regulations and thus was not a signed return). Therefore, we do not think the return filed by the third-party payor under the facts presented in Scenario (4) should be considered the employer's return, i.e., the taxpayer's return, for purpose of section 6501.

What is clear from the memorandum is a belief by the IRS that if the organization hired by the employer to "take care" of the payroll filings or the whole human resource area (as many PEOs will) fails to strictly comply with the rules outlined by the IRS, it is their clients that will be potentially exposed to continuing liability.

Section: 4980H
Employer Reporting and Shared Responsibility Payments Delayed Until 2015

Citation: Notice 2013-45, 7/9/13

In Notice 2013-45 (http://www.irs.gov/pub/irs-drop/n-13-45.pdf/n-13-45.pdf) the IRS formally announced what the Treasury had previously disclosed on a blog—that the insurers, self-insuring employers and certain other provider reporting of minimum essential coverage under §6055 and the information reporting requirements of large employers of coverage under §6056 have been delayed until 2015.

The notice also provides that since employers do not possess enough information to self-assess the shared responsibility payments under §4980H and the government, which will eventually bill for that payment, will lack the necessary information to compute the payments due, no payments will be assessed for 2014. The notice also provides that the delay in these provisions will not affect any other provision of the Affordable Care Act scheduled to go into effect in 2014, including the premium credit under IRC §36B or the individual shared responsibility provisions under §5000A (the individual "pay or play" penalty).

Section: 5000A
Restrictions on Maximum Deductibles for Plans in Small Group Market Retroactively Removed from Affordable Care Act

Citation: Protecting Access to Medicare Care Act of 2014, Public Law No. 113-93,

In the Protecting Access to Medicare Care Act of 2014, Public Law No. 113-93, http://beta.congress.gov/113/bills/hr4302/BILLS-113hr4302enr.pdf, Congress retroactively removed a provision of the Affordable Care Act (ACA) that provided a limit on deductibles for policies issued in the small group market.

Under the ACA as originally enacted, policies offered in the small group market could not have a deductible in excess of $2,000 for self-only coverage or $4,000 for any other coverage (that is "family" coverage) beginning in 2014.

Section 213 of the Act repealed the relevant provision found in Section 1302(c) of the 2010 Affordable Care Act. This change applies as if it were originally part of the Affordable Care Act.

Section: 5000A
SBA and DOL Announce No Penalty Applies for Failure of Employers to Issue Required Notice of Coverage

Citation: Department of Labor Frequently Asked Questions, Notice on Coverage Options, 9/12/13

Most employers were required to issue notices of coverage options for health insurance to their employees by October 1, 2013. Over the summer, many commentators warned that a failure to issue such notices would trigger a $100 penalty provided for under the Affordable Care Act for such a failure.

However, in September both the Small Business Administration (http://www.sba.gov/community/blogs/community-blogs/health-care-business-pulse/myth-vs-fact-myth-3-business-owners-will-be-fined-if-they-don%E2%80%99t-notify-their-employees-about-new-health-insurance-marketplace) and the Department of Labor (http://www.dol.gov/ebsa/faqs/faq-noticeofcoverageoptions.html) provided guidance indicating that no penalty was to apply on such a failure.

So, as it stands now, such notices are required—but there is no penalty imposed on the employer for failure to comply with the requirement.

Advisers should be aware, though, that this would still be a failure to comply with the law. That can create issues—for instance, Congress enacted a requirement that tax preparers must electronically file individual and fiduciary tax returns in most cases. Like this rule, there was no penalty provided for failure to comply. However, the Office of Professional Responsibility ruled that a failure to comply with this law by the preparer was actionable, since failing to comply with the law was a discreditable act by the preparer.

Similarly, it's possible that future litigation by an employee may raise an issue regarding the employer's failure to comply with the requirements. So, generally, advisers do not want to be advising clients to simply ignore these rules. The Department of Labor notice cited above has links to the notices that employers should have been, and should continue to issue.

Section: 6033
Retroactive Reinstatement of Tax Exempt Status Relief Provisions Issued for Organizations Losing Tax Exempt Status Under Three Year Nonfiling Rule

Citation: Revenue Procedure 2014-11, 1/2/14

In Revenue Procedure 2014-11 (http://www.irs.gov/pub/irs-drop/rp-14-11.pdf) the IRS provides various processes to retroactively restore tax exempt status to organizations that lost that status due to failure to file the "e-Postcard" Form 990-N and/or Form 990-EZ for three consecutive years.

Under IRC §6033(j)(1) most tax-exempt organizations, regardless of revenue received, must file an annual report and those that fail to do so for three straight years have their status revoked. Unfortunately many small tax-exempt organizations failed to get the message about this requirement. As well, many lack any sort of non-volunteer staff to assure that such filing requirements are met.

The ruling is meant to allow such organizations to restore their tax-exempt status without having to start the exemption process all over again and to do so retroactively. Retroactive restoration allows the organization to retain its exemption from taxation during the period when otherwise it would've been subject to tax and allow donors to §501(c)(3) organizations to claim charitable deductions made during the period following loss of exemption.

The ruling provides for a number of different paths down which organization may travel in order to restore it status.

The first path is used by an organization that has not previously lost tax-exempt status and files for restoration within 15 months of the later of the date of the IRS Revocation Letter to the organization or the date on which the IRS posts the organization's name on the Revocation List (found at http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check).

Under this method of restoration of status an organization does not have to show reasonable clause for failure. The details of this method are found in section 4 of the Revenue Procedure. The organization completes and submits an application not later than 15 months after the date of revocation and writes "Revenue Procedure 2014–11, Streamlined Retroactive Reinstatement" at the top of the application. The organization must submit a user fee in the amount determined from the annual Revenue Procedure that outlines user fees. For 2014 that will be Revenue Procedure 2014-8, Section 6.09.

The 2014 user fee is $400 for the organization with average gross receipts of not more than $10,000 during the prior four years, and $850 for all other organizations.

No penalties will be imposed so long as the organization files a properly completed paper Form 990-EZ for each of the three years when it was required to file that form. If the organization was eligible to file a Form 990-N for any of the years it does not have to file any document for that year and will not be penalized for the failure.

The second path is used by an organization that is not eligible to use the first path but is still applying for reinstatement within 15 months of the layer of the date of the IRS revocation letter to your station or the date on which the IRS posts the organization's name on the Revocation List noted above.

Such an organization will follow the procedures found in Section 5 of the Revenue Procedure. In addition to the requirements noted for the first path described above, the organization must do each of the following:

- Include a statement outlining reasonable cause for failure to file at least one of the missed returns
- Include a statement that it has filed the required paper returns described in the procedure. These paper returns will be properly completed and executed returns for the taxable years in the consecutive three-year period when it failed to file the returns and any subsequent period before it applied for reinstatement. These returns will be sent to the address found in Section 5.

The third path is used by an organization that fails to request reinstatement within 15 months. The major difference for these organizations versus those described merely above is that the organization must provide reasonable cause for all years in which a failure to file occurred.

Finally, Section 7 describes the option to apply for your reinstatement only on a prospective basis from the date the organization files for reinstatement of its tax-exempt status. Any organization may elect to use this method in lieu of the other methods that may qualify for, though obviously organizations that do not qualify for any of the previous relief provisions will have to use this method.

Section 8 of the Revenue Procedure goes on to describe factors that indicate the existence of reasonable cause. No one factor is determinative of reasonable cause status, and each case is to evaluated based on the overall situation.

The factors enumerated in the Revenue Procedure are:

- The organization's failure was due to its reasonable, good faith reliance on erroneous written information from the IRS, stating that the organization was not required to file a return or notice under section 6033, provided the IRS was made aware of all relevant facts;
- The failure to file the return or notice arose from events beyond the organization's control ("impediment") that made it impossible for the organization to file a return or notice for the year;
- The organization acted in a responsible manner by undertaking significant steps to avoid or mitigate the failure to file the required return or notice and to prevent similar failures in the future, including, but not limited to—
  - Attempting to prevent an impediment or a failure, if it was foreseeable;
  - Acting as promptly as possible to remove an impediment or correct the cause of the reporting failure, once the failure was discovered; and
  - After the failure was discovered, implementing safeguards designed to ensure future compliance with the reporting requirements under section 6033; and
- The organization has an established history of complying with its reporting requirements (if any) under section 6033 and/or any other applicable reporting or other requirements under the Code.

A reasonable cause statement must also include the following statement signed under penalties of perjury.

> I, (Name), (Title) declare, under penalties of perjury, that I am authorized to sign this request for retroactive reinstatement on behalf of [Name of Organization], and I further declare that I have examined this request for retroactive reinstatement, including the written explanation of all the facts of the claim for reasonable cause, and to the best of my knowledge and belief, this request is true, correct, and complete.

The revenue procedure is effective for applications submitted after January 2, 2014. The procedure also contains provisions giving relief to organizations that previously received prospective reinstatement only of their tax-exempt status. If such an organization would have qualified for reinstatement under these procedures the revenue procedure in Section 10 outline steps to be taken to obtain reinstatement retroactively.

Section: 6041
Memorandum Outlines Situations Where LLCs are Exempted from Requirements to Be Issued Certain 1099s

Citation: Chief Counsel Advice 201447025, 11/21/14

Chief Counsel Advice 201447025 clarified the circumstances under which an information return must be issued to a limited liability company (LLC) under the rules of §6041.

Under IRC §6041 all taxpayers engaged in a trade or business must payments made in the course of the trade or business for rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income in the amount of $600 or more for the year. However, such reporting is not required if the payment is made to a corporation (as described in Reg. §1.6049-4(c)(1)(ii)(A).

In the situation in question, a taxpayer had claimed that no reporting was necessary for such payments made to various LLCs, as such entities are exempt from reporting. Therefore, the taxpayer argued, no backup withholding applied pursuant to §3406.

The memo pointed out first that LLCs are only within the definition of corporations if they elect to be treated as a corporation under Reg. §301.7701-3(a). If an LLC makes such an election, it would be a corporation and exempt from payments.

Similarly, even if an LLC is treated as a partnership, it can also escape the requirement for reporting if all of its members are corporations and it files with the payor a statement stating each member of the partnership is a corporation.

In this case the payor had no record either that the LLCs had made an election to be treated as a corporation, nor that they were partnerships of which all members were corporations. Thus, a Form 1099 was required in this case and the backup withholding rules applied.

Section: 6041
1099s Must Be Issued to Veterinary Corporations for Payments for Services by a Business

Citation: Chief Counsel Advice 201349013, 12/6/13

In Chief Counsel Advice 201349013, http://www.irs.gov/pub/irs-wd/1349013.pdf, the question of whether 1099s must be issued for payments made to an incorporated veterinarian by a customer who makes the payments in the course of the customer's trade or business.

Generally under IRC §6041 information returns must be filed by any business for payments made for services in excess of $600 per year to a payee. Generally payments to corporations are exempted from this requirement. The ruling notes, though, that:

> However, under Treas. Reg. § 1.6041-3(p)(1) corporations "engaged in providing medical and healthcare services" are not exempted from the reporting requirement.

The ruling concludes, based on other applications of the term "medical and healthcare services" that a veterinary corporation is engaged in such services. As such, a business paying more than $600 to a corporation for veterinary services for services in the course of that business will need to issue an information return to the corporation.

That is, a veterinary corporation is not exempt from the Form 1099 reporting requirements for services.

Section: 6042
Truncated EIN Information Return Program Made Permanent, Revisions Made to Program

Citation: TD 9675, 7/15/14

In TD 9675 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-16464.pdf) the IRS issued final regulations making permanent what had been an experimental program allowing entities issuing information returns to truncate identification numbers to only four digits on such returns. The program was initiated due to concerns regarding the risk of identity theft if such forms managed to fall into the hands of those other than to whom the information return was addressed.

Previously the IRS had issued proposed regulations in this area, but had provided that issuers could rely upon those regulations until final regulations were issued.

The final regulations expanded the program somewhat. First, the IRS modified the program to allow truncation not only of social security numbers, but also of employer identification numbers. The IRS took this action in response to complaints that small business taxpayers have concerns regarding the misuse of their

EINs that are similar to individual's concerns regarding social security numbers and some payors had complained that their systems could not easily differentiate between social security numbers and EINs, thus making it impossible to make use of truncated number reporting on their reports.

The IRS also modified the regulations so that, rather than providing a list of information returns on which truncated numbers could be used, the regulation provides that truncated identification numbers may be used on all returns except those the IRS specifically prohibits their use on.

The IRS did make clear in the preamble that this only applies to information returns to recipients, and does not apply to things such as W-4s and W-9s, nor to the payor's provision of its identification number on information returns.

The final regulation is effective on and after July 15, 2014.

Section: 6047
Electronic Filing Requirements for Retirement Plans Finalized by the IRS

Citation: TD 9695, 9/29/14

The IRS issued final regulations in TD 9695 that will require the filing of certain retirement plans forms in electronic format for plans that are required to file more than 250 returns with the IRS via Regulations §§301.6057-3, 301.6058-2 and 301.6059-2.

The affected forms include the following:

- Form 5500 series forms (Form 5500, 5500-SF and 5500-EZ)
- The actuarial reports of Schedule SB and Schedule MB
- Form 8965-SSA

These rules apply to plan years beginning on or after January 1, 2014 with filing deadlines (without regard to extensions) after December 31, 2014.

For Form 8965-SSA (used to report former participants for whom the plan holds vested benefits), the regulations provide that the current voluntary electronic system (Filing Information Returns Electronically or FIRE system) will be an accepted means to file the form for the mandatory electronic filing of such forms.

As a practical matter, while one part of this regulation technically applies to the Form 5500 series, aside from the Form 5500-EZ such forms were already required to filed electronically using the ERISA Electronic Filing Acceptance System (EFAST2) under Department of Labor rules. If a Form 5500-EZ manages to run afoul of these rules (seemingly an unlikely occurrence), the IRS provides that the plan will report electronically via EFAST2 using Form 5500-SF without having to attach either a Schedule SB or Schedule MB.

One practical problem the IRS had to resolve involved delinquent returns. The IRS is not yet able to accept electronically any of the above forms electronically. The regulations provide that a delinquent filing that complies with the provisions of Notice 2014-35 (related to late filing under IRC §§6047(e), 6057, 6058 and 6059) and Revenue Procedure 2014-32 (a pilot program for late filing relief of Forms 5500-EZ) will not be required to file electronically if the plan complies with the paper filing requirements of the Notice and/or Revenue Ruling.

While the regulations provide for an economic hardship waiver from a required electronic filing, the IRS makes clear they do not expect to find many cases where they will agree electronic filing presents a true economic hardship for the filer. As well, since electronic filing of Forms 5500 and 5500-SF have been previously required by the Department of Labor, the IRS does not plan to offer an electronic filing hardship waiver procedure for those forms.

Section: 6050P
IRS Proposes Removal of 36 Month Test for Issuance of Forms 1099C by Lenders

Citation: REG-136676-13, 10/10/14

The IRS has issued proposed regulations (REG-136676-13) that would eliminate the "36 month" non-payment testing period for certain lenders to issue Forms 1099C. The IRS believes that this rule creates confusion regarding the proper reporting of cancellation of debt income.

Taxpayer has cancellation of debt income generally upon the occurrence of the first "identifiable event" where it is clear that the lender has no intention of attempting to enforce collection on the debt and the borrower has no intention to repay the debt.

Under Reg. §1.6050P-1(b)(2)(iv) a 36 month rules was created that generally creates a rebuttable presumption that an identifiable event has occurred if a lender does not receive a payment during a 36 month testing period. A lender can rebut that presumption if the lender has made bona fide collection efforts during the 12 month period ending as of the end of the calendar year in which the 36 month period ends or if facts and circumstances indicate that the debt has not been discharged.

The 36 month test is only of eight situations that are listed as identifiable events requiring the filing of a Form 1099C by the lender. The other seven tests, which would still be in place even if these regulations are made final, are:

- A discharge of indebtedness under the Bankrutpcy Code;
- A cancellation or extinguishment of an indebtedness that renders the debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or state court, as described in section 368(a)(3)(A)(ii) (other than a discharge under the Bankruptcy Code);
- A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection (but only if, and only when, the debtor's statute of limitations affirmative defense has been upheld in a final judgment or decision in a judicial proceeding, and the period for appealing it has expired) or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding;
- A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;
- A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
- A discharge of indebtedness pursuant to an agreement between an applicable entity and a debtor to discharge indebtedness at less than full consideration;
- A discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt;

The IRS notes that the seven that would remain are all objective events that are truly linked to an actual discharge of the debt, unlike the 36 month test. As the preamble to the proposed regulations note, this test was added to the regulations to replace a "facts and circumstances" test due to complaints by lenders that they wanted an objective test.

The problem, however, is that the rules for actual recognition of cancellation of debt income have traditionally demanded an actual (and not this sort of arbitrarilary selected) identifiable event. So, for most taxpayers, a Form 1099C issued based solely on the 36 month test did not actually identify the actual date when the income event took place (if it actually had by that point).

Section: 6050W
IRS Extends Reprieve From Penalties for Payors Reporting Incorrect TINs on Form 1099K for 2012 Filings

Citation: Notice 2013-56, 9/4/13

In Notice 2013-56 (http://www.irs.gov/pub/irs-drop/n-13-56.pdf) the IRS extended the period during which the IRS will not penalize filers of Form 1099-K who reported erroneous taxpayer identification numbers on form filed in 2013 for payments made in 2012. The IRS had previously pushed back the date for assessing penalties from the original first year for required filings of 2011 to 2012—now the IRS has extended that relief one more time.

As well, the notice provides that the IRS will not issue CP2100/CP2100A notices regarding name and TIN mismatches on Forms 1099-K until late 2014, doing so for forms filed in 2014 for payments made in 2013. However the IRS reminded payors that a CP2100/CP2100A notice is not a necessary precondition to trigger backup withholding if a payor does not provide a TIN or provides an obviously wrong TIN.

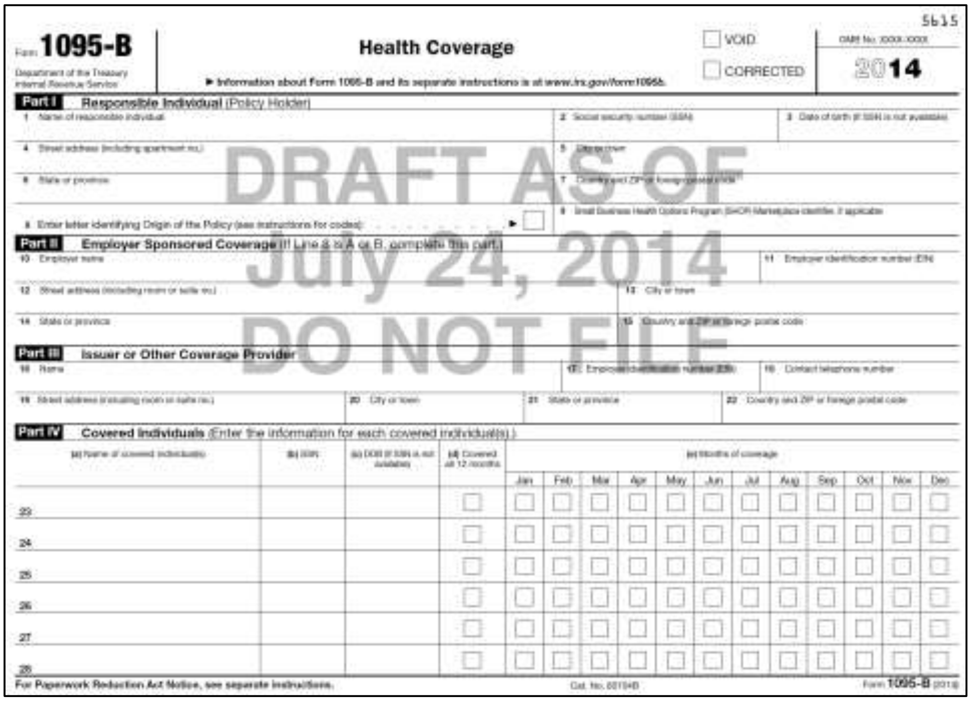
Section: 6055
IRS Releases Drafts of ACA Information Reporting Forms

Citation: Draft Forms 1094-B, 1094-C, 1095-B and 1095-C, 7/24/14

The IRS has issued drafts of various reporting forms related to insurance coverage

Insurers and plan sponsors of self-insured plans will be required, under IRC §6055, to report health coverage provided to individuals.

An individual will be issued a Form 1095-B, the draft of which is available at http://www.irs.gov/pub/irs-dft/f1095b--dft.pdf.



5615

Form **1095-B**

Department of the Treasury
Internal Revenue Service

Health Coverage

▶ Information about Form 1095-B and its separate instructions is at www.irs.gov/form1095b.

VOID

CORRECTED

OMB No. XXXX-XXXX

2014

DRAFT AS OF
July 24, 2014
DO NOT FILE

Part I **Responsible Individual** (Policy Holder)

1 Name of responsible individual

2 Social security number (SSN)

3 Date of birth (if SSN is not available)

4 Street address (including apartment no.)

5 City or town

6 State or province

7 Country and ZIP or foreign postal code

8 Enter letter identifying Origin of the Policy (see instructions for codes): ▶

9 Small Business Health Options Program (SHOP) Marketplace identifier, if applicable

Part II **Employer Sponsored Coverage** (If Line 8 is A or B, complete this part.)

10 Employer name

11 Employer identification number (EIN)

12 Street address (including room or suite no.)

13 City or town

14 State or province

15 Country and ZIP or foreign postal code

Part III **Issuer or Other Coverage Provider**

16 Name

17 Employer identification number (EIN)

18 Contact telephone number

19 Street address (including room or suite no.)

20 City or town

21 State or province

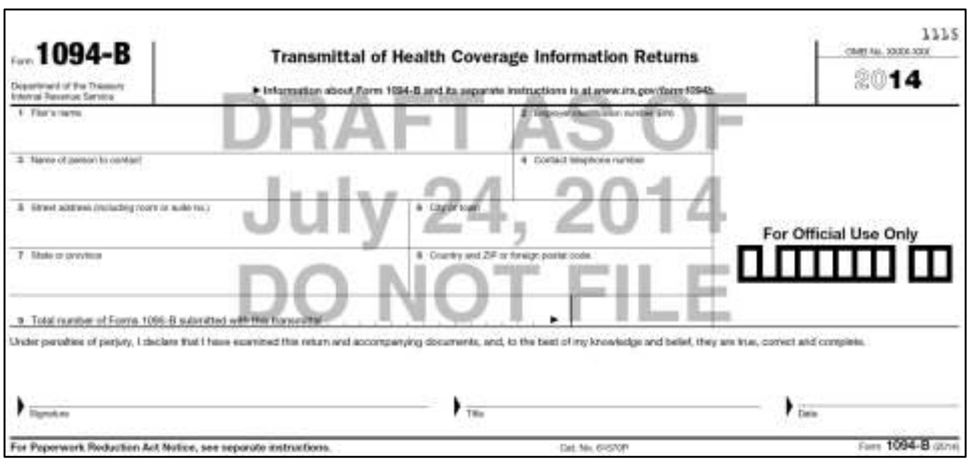
22 Country and ZIP or foreign postal code

Part IV **Covered Individuals** (Enter the information for each covered individual(s).)

	(a) Name of covered individual(s)	(b) SSN	(c) DOB (if SSN is not available)	(d) Covered all 12 months	(e) Months of coverage											
					Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
23				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
24				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
25				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
26				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
27				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
28				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60704B Form **1095-B** (2014)

The forms will be transmitted to the IRS with a Form 1094-B which has also been issued in draft form available at



1115

Form **1094-B**

Department of the Treasury
Internal Revenue Service

Transmittal of Health Coverage Information Returns

▶ Information about Form 1094-B and its separate instructions is at www.irs.gov/form1094b.

OMB No. XXXX-XXXX

2014

DRAFT AS OF
July 24, 2014
DO NOT FILE

1 Filer's name

2 Employer identification number (EIN)

3 Name of person to contact

4 Contact telephone number

5 Street address (including room or suite no.)

6 City or town

7 State or province

8 Country and ZIP or foreign postal code

For Official Use Only

9 Total number of Forms 1095-B submitted with this transmittal ▶

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct and complete.

▶ Signature ▶ Title ▶ Date

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 61570P Form **1094-B** (2014)

Applicable large employers will also need to provide employees with information returns related to coverage. For such employers the new form will be Form 1095-C, a draft version of which is available at http://www.irs.gov/pub/irs-dft/f1095c--dft.pdf.

Form **1095-C** — Department of the Treasury, Internal Revenue Service

Employer-Provided Health Insurance Offer and Coverage

▶ Information about Form 1095-C and its separate instructions is at www.irs.gov/f1095c.

DRAFT AS OF July 24, 2014 DO NOT FILE

☐ VOID ☐ CORRECTED — 6015 — OMB No. XXXX-XXXX — 2014

Part I Employee

1 Name of employee | 2 Social security number (SSN)
3 Street address (including apartment no.)
4 City or town | 5 State or province | 6 Country and ZIP or foreign postal code

Applicable Large Employer Member (Employer)

7 Name of employer | 8 Employer identification number (EIN)
9 Street address (including room or suite no.) | 10 Contact telephone number
11 City or town | 12 State or province | 13 Country and ZIP or foreign postal code

Part II Employee Offer and Coverage

	All 12 Months	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
14 Offer of Coverage (enter required code)													
15 Employee Share of Lowest Cost Monthly Premium, for Self-Only Minimum Value Coverage	$	$	$	$	$	$	$	$	$	$	$	$	$
16 Applicable Section 4980H Safe Harbor (enter code, if applicable)													

Part III Covered Individuals

If Employer provided self-insured coverage, check the box and enter the information for each covered individual. ☐

	(a) Name of covered individual(s)	(b) SSN	(c) DOB (If SSN is not available)	(d) Covered all 12 months	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
17				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
18				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
19				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
20				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
21				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
22				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

(e) Months of Coverage: Jan–Dec

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60705M Form **1095-C** (2014)

These forms will be transmitted to the IRS with a Form 1094-C the draft of which is available at http://www.irs.gov/pub/irs-dft/f1094c--dft.pdf.

Form **1094-C** — Department of the Treasury, Internal Revenue Service

Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns

▶ Information about Form 1094-C and its separate instructions is at www.irs.gov/f1094c.

DRAFT AS OF July 24, 2014 DO NOT FILE

☐ CORRECTED — 120115 — OMB No. XXXX-XXXX — 2014

Part I Applicable Large Employer Member (ALE Member)

1 Name of ALE Member (Employer) | 2 Employer identification number (EIN)
3 Street address (including room or suite no.)
4 City or town | 5 State or province | 6 Country and ZIP or foreign postal code
7 Name of person to contact | 8 Contact telephone number
9 Name of Designated Government Entity (only if applicable) | 10 Employer identification number (EIN)
11 Street address (including room or suite no.)
12 City or town | 13 State or province | 14 Country and ZIP or foreign postal code
15 Name of person to contact | 16 Contact telephone number

For Official Use Only

17 Reserved . . . . ☐

18 Total number of Forms 1095-C submitted with this transmittal . . . . . . ▶

Part II ALE Member Information

19 Is this the authoritative transmittal for this ALE Member? If "Yes," check the box and continue. If "No," see instructions . . . . ☐

20 Total number of Forms 1095-C filed by and/or on behalf of ALE Member . . . . . . ▶

21 Is ALE Member a member of an Aggregated ALE Group? . . . . . . ☐ **Yes** ☐ **No**
If "No," do not complete Part IV.

22 Certifications of Eligibility (select all that apply):

☐ **A.** Qualifying Offer Method ☐ **B.** Qualifying Offer Method Transition Relief ☐ **C.** Section 4980H Transition Relief ☐ **D.** 98% Offer Method

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and to the best of my knowledge and belief, they are true, correct, and complete.

▶ Signature ▶ Title ▶ Date

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 61571A Form **1094-C** (2014)

Form 1094-C (2014) 120215 Page 2

Part III ALE Member Information—Monthly

		(a) Minimum Essential Coverage Offer Indicator		(b) Full-Time Employee Count for ALE Member	(c) Total Employee Count for ALE Member	(d) Aggregated Group Indicator	(e) Section 4980H Transition Relief Indicator
		Yes	No				
23	All 12 Months	☐	☐			☐	
24	Jan	☐	☐			☐	
25	Feb	☐	☐			☐	
26	Mar	☐	☐			☐	
27	Apr	☐	☐			☐	
28	May	☐	☐			☐	
29	June	☐	☐			☐	
30	July	☐	☐			☐	
31	Aug	☐	☐			☐	
32	Sept	☐	☐			☐	
33	Oct	☐	☐			☐	
34	Nov	☐	☐			☐	
35	Dec	☐	☐			☐	

Form 1094-C (2014)

For the 2014 tax year reporting on these forms is voluntary [Notice 2013-45], though such reporting will be mandatory for 2015 (with the Forms 1095 mailed to affected individuals in January 2016).

Section: 6055
Proposed Rules Issued for Provider and Employer Reporting of Health Care Coverage Under Affordable Care Act

Citation: REG-132455-11 and REG-136630-12, 9/6/13

The IRS has issued proposed regulations regarding reporting under the Affordable Care Act for insurers and employers under IRC §§6055 and 6056. REG-132455-11 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2013-21783.pdf) deals with reporting by providers of minimum essential coverage under §6055 while REG-136630-12 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2013-21791.pdf) outlines proposed rules governing reporting by applicable large employers (ALEs) on compliance the shared responsibility provisions under IRC §4980H and about health coverage they have offered to employees.

The proposed regulations are still a work in progress, with the IRS suggesting various potential simplified reporting options, including allowing employers to combine some reports either into a single substitute report or providing for reporting on an employee's W-2 in lieu of issuing a separate report to the employee. The IRS is specifically seeking additional comments regarding various portions of these rules.

Employers and providers of minimum essential coverage will need to continue to monitor developments regarding these regulations as we approach the mandated reporting dates, now generally pushed back to calendar year 2015 with annual reports first being due in January 2016.

Section: 6501
Even Though Statute Expired Under §4979A, Failure to File Form 5330 Meant Statute Remained Open Under §6501 to Assess Excise Tax on ESOP

Citation: Law Office of John H. Eggertsen, P.C. v. Commissioner, 143 TC No. 13, 10/1/14

In ruling on a motion for reconsideration in the case of *Law Office of John H. Eggertsen, P.C. v. Commissioner*, 143 TC No. 13 the Tax Court addressed the interaction of provisions governing the statute of limitations for the excise tax on prohibited allocations of employer securities in an ESOP imposed by IRC §4979A.

Generally that tax, like most other excise taxes imposed on a retirement plan, is reported on a Form 5330, Return of Excise Taxes Related to Employee Benefit Plans, for the year in question. The IRS argued, and the Tax Court agreed in the original case, 142 TC No. 4, that an excise tax should have been paid.

However, in that case the IRS argued only that the statute of limitations on assessing tax was governed by IRC §4979A(e)(2)(D) which provides that the statute shall not expire before the date which is 3 years from the later of the allocation that gave rise to the tax or the date on which the IRS is notified of the ownership.

The Tax Court found, in that case, that the IRS was in possession of information from the Form 1120S and Form 5500 filed that the ESOP owned all stock and that there were only three participants, thus making it clear that the ownership tests would be met. Thus, the IRS was found to be properly notified more than three years before the assessment was issued.

The IRS, in arguing for reconsideration, claimed that the Tax Court had a responsibility to consider whether the general rules of §6501(a) applies. The IRS argued, and the Tax Court agreed in the second decision, that §4979A serves only to extend, and not reduce, the statute of limitations in this case.

To trigger the statute under §6501(a) (the general statute of limitations provision), a taxpayer must file an original return. The taxpayer did not file a Form 5330 for the year in question and the Court found the taxpayer did not file any other document that would qualify as a return for the §4979A excise tax.

To qualify as a return for these purposes, that other document would have to meet the following four tests:

- Contain sufficient information to calculate the taxpayer's tax liability,
- Purport to be a return,
- Constitute an honest and reasonable attempt by the taxpayer to satisfy the requirements of the Federal tax law, and
- Be executed under penalties of perjury

The Court found no document submitted by the taxpayer met all of those requirements. While notification of ownership might have been made, the taxpayer had not provided sufficient information to allow the IRS to calculate the taxpayer's liability.

Thus, upon reconsideration, the Tax Court concluded that the statute for assessing the tax remained open under IRC §6501(a) since no return had been filed.

Section: 6652
IRS Issues Late Filer Form 5500 Relief for DOL DFVC Program Participants and Pilot Program for Form 5500-EZ Filers

Citation: Notice 2014-23 and Revenue Procedure 2014-32, 5/9/14

The IRS issued a Notice (Notice 2014-23, http://www.irs.gov/pub/irs-drop/n-14-35.pdf) and a Revenue Procedure (Revenue Procedure 2014-32, http://www.irs.gov/pub/irs-drop/rp-14-32.pdf) that grant relief to certain late filers of employee benefit plan returns.

Notice 2014-23 applies to Form 5500 filers whose plan is covered by Title I of ERISA where the filer qualifies for and satisfies the requirements of the Department of Labor's Delinquent Filer Voluntary Compliance (DFVC) program and files separately with the IRS by the later of 30 days after the filer completes the DFVC filing or December 1, 2014 on paper any Form 8955-SSA with required information that has not been previously provided to the IRS.

The IRS explained that while generally the Form 5500 series forms are required to be filed electronically via DOL's EFAST2 program and the IRS encourages electronic filing, the IRS electronic systems cannot currently process Forms 8955-SSAs for a relief program. Thus a paper Form 8955-SSA is to be filed, with the "special extension" box checked on Line C, Part I of Form 8955-SSA and enter "DFVC" in the space provided on Line C.

Filers meeting the requirements of the notice will escape the imposition of penalties by the IRS under §§6652(d) and 6652(e) or under §6692. These penalties are distinct from the Department of Labor penalties under section 502(c)(2) of ERISA and 29 CFR 2575.502c-2 of $1,100 per day late that are waived under the DFVC program.

However this relief is not available for plans not covered by Title I of ERISA, as such plans are not subject generally to Department of Labor penalties or jurisdiction and, thus, are not eligible for the DOL's DFVC program. However such plans (generally "one participant" Form 5500-EZ small business plans and foreign plans) are still subject the IRS imposed penalties noted above which can run as high as $15,000 per delinquent year.

Revenue Procedure 2014-32 provides for a one year pilot program running from June 2, 2014 to June 2, 2015. During the pilot period there will be no user fee imposed, but the IRS has indicated that if the program is made permanent there will be a user fee under this program.

To qualify for relief a filer must not have received a CP 283 Notice, *Penalty Charged on Your 5500 Return* for the late return.

The IRS provides that the entity should "[f]ile the late return plus any required schedules and attachments, using the original IRS form for that year (but use only a Form 5500-EZ for 2009 and later years even if the plan could've originally submitted a Form 5500-SF). Annual actuarial reports for defined benefit plans need to be prepared even if they are not required to be included with the filed return."

The IRS also requires the filer to "[w]rite in red letters in the top margin of the first page above the title of the form "Delinquent return submitted under Rev. Proc. 2014-32, Eligible for Penalty Relief" on each late return that you submit (failure to do this may cause your late return to be ineligible for penalty relief)."

A one page transmittal schedule should be attached to the front of each return, and the returns must be filed in paper form (no electronic filing). The forms are filed to the addresses noted in the Revenue Procedure.

Section: 6657
IRS Discusses Reasonable Cause and First Time Abatement in a Payroll Tax Context

Citation: Chief Counsel Email 201414017, 4/4/14

An analysis of criteria to be used for making the determination of whether a taxpayer has demonstrated "reasonable cause" for late deposits of payroll taxes is found in Chief Counsel Email 201414017 (http://www.irs.gov/pub/irs-wd/1414017.pdf).

In the case the taxpayer had failed to timely deposit payroll taxes related to the exercise of nonqualified stock options. The taxpayer had relied upon a third-party payroll processing company to make the deposits, something that was not done timely. The company had a history of timely payment of other required deposits. When the taxpayer discovered that the deposits were not being made, it implemented new procedures to assure that such deposits would be made timely in the future and immediately deposited the overdue tax.

The email concludes that while the actions to immediately deposit the unpaid tax and to develop procedures to insure the problem would not occur in the future met the requirements to show the exercise of ordinary business care and a lack of willful neglect, the email concludes that it fails to justify the reliance on faulty procedures to begin with. For that reason, the taxpayer is, in the view of the email's author, unable to show that, despite the exercise of ordinary business care and prudence, it was rendered unable to meet its responsibilities.

The email also goes on to discuss some issues related to the First Time Abatement procedures outlined in IRM 20.1.1.3.6.1, even though the agent asking for guidance had already come to the conclusion that it did not apply and the taxpayer had not asked for relief under the FTA procedures.

The email, though, explains that the FTA is an administrative rule of the IRS only, thus it would be within the IRS's discretion, and would make sense, to make use of the FTA even if the tax had not been assessed if the taxpayer met the criteria. The email notes that to do otherwise (that is, assess the tax, have the taxpayer ask for relief and then grant an abatement) would be a waste of resources.

The memo also concludes that the FTA can only, at this time, apply to the earliest period in question rather than being available to offset the greatest penalty amount if a number of payment dates are involved. While the agency would have the authority to grant relief administratively to any such period, the IRM specifically limits the FTA to the first period in question and until the Service changes the IRM agents must follow those procedures.

Section: 6672
Owner Who Found Manager Embezzled Payroll Taxes Rather Than Pay Them Still Managed to Make Himself Liable for the Trust Fund Penalty

Citation: Shore v. U.S., DC ID, 114 AFTR 2d ¶2014-5496, 12/4/14

William Shore discovered that the individual he placed in charge of the company he owned, but which he was not directly involved in at the time, had been embezzling funds from the company and not paying bills—including payroll tax deposits. Unfortunately, the actions Mr. Shore took after becoming aware of these facts caused him to become liable for trust fund penalties in the case of *Shore v. U.S.,* DC ID, 114 AFTR 2d ¶2014-5496.

Mr. Shore had leased property to a farm equipment seller until late 2004, when the dealer closed. However, a representative of a line of tractor's his old tenant had sold suggested that Mr. Shore should start his own business on the property and sell that line of tractors.

Mr. Shore did not have interest at first, since he was retired and lived far from the property. However, the representative suggested that he could hire the manager of his old tenant to run the operation, as he had 25 years of experience buying and selling tractors.

Based on this recommendation, Mr. Shore hired the manager. The manager was to run the business and have the option to purchase it by repaying Mr. Shore's initial $150,000 investment in the business plus interest. The manager effectively treated the business as his company, including holding himself out to the accountant that was hired to work for the company as the owner. But he never actually exercised the option to purchase the company.

Mr. Shore had very limited involvement with the company. However, in 2005 he became aware of unpaid payroll taxes. He ordered the manager to pay those taxes and insured he actually did so.

In August of 2007 Mr. Shore received a letter from the IRS raising questions about the payroll taxes of the company for 2006 and 2007. As Mr. Shore investigated this matter, he became aware that the manager had not only failed to pay the payroll taxes, but also had not paid numerous other bills of the company. However, he had taken funds for himself without authorization (likely part of the reason why the bills went unpaid).

Mr. Shore fired the manager and took control of the company himself. Ultimately he concluded the company was simply too far underwater for him to rescue—he didn't have the necessary funds to pay off the debts that needed to be paid and have remaining funds necessary to operate the business.

However he did allow $120,000 of payments to be made to creditors other than the IRS during this period in which he was in charge—and that was a big problem.

As the Court explained in its ruling:

> Shore suggests his conduct was not willful because he did not know about BRE's tax liability at the time BRE failed to remit payroll taxes in 2006 and 2007. (Dkt. 22, p. 16.) However, a taxpayer may act "willfully" for purposes of § 6672 even though he does not learn about unpaid taxes until after the corporation has failed to pay them. *Johnson*, 734 F.3d at 364. When "a responsible person learns that withholding taxes have gone unpaid in past quarters for which he was responsible, he has a duty to use all current and future unencumbered funds available to the corporation to pay those back taxes." *Erwin*, 591 F.3d at 326. If the taxpayer instead knowingly permits payments of corporate funds to be made to other creditors, a finding of willfulness is appropriate.Id. ("Even assuming ... that [the taxpayer] did not act willfully prior to learning of the full extent of the tax deficiencies ..., his conduct *after* that point unquestionably evidences willfulness as a matter of law.") (emphasis in original).

Mr. Shore likely believed he acted reasonably in the case—he was initially trying to keep the doors open and keep the individuals working in the organization employed. So he paid the bills to keep the doors open during the time he was gathering information to determine if the business could be salvaged.

But, unfortunately, the mere fact he was trying to be "good guy" doesn't absolve him of responsibility for the trust fund penalties.

Section: 6672
CFO Still Responsible Person Despite Lender's Refusal to Advance Funds to Pay Payroll Taxes, Rather Demanding Payment of Other Expenses

Citation: In re: Cherne, Bankruptcy Court of Idaho, Bankruptcy Case No. 12-02327-JDP, 8/7/14

The fact that a lender stated it would only advance a hospital funds to pay bills if it was allowed to approve all disbursements did not allow the CFO to escape a trust fund penalty in the case of *In re: Cherne*, Bankruptcy Court of Idaho, Bankruptcy Case No. 12-02327-JDP.

The individual in question was a CPA who was serving as CFO of a financially troubled hospital in which he had an interest. Mr. Cherne kept the accounting for the hospital, advanced it $500,000 of his own funds and personally guaranteed $30 million in hospital debts.

Mr. Cherne negotiated loans on behalf of the hospital and had signature authority over all of the hospital's bank accounts. He prepared regular financial statements which dutifully disclosed that the hospital was not current in paying its payroll tax obligations.

The hospital fell into default with the lender who had given it $10 million for its construction. The lender agreed to loan the hospital additional money, but only if the lender could exercise significant control over the hospital's spending.

The hospital, not seeing an alternative (apparently just closing shop wasn't considered a possible solution), appeared to agree to such an arrangement. Although not reduced to writing, the parties agreed that the hospital would prepare a list of outstanding bills which it sent to the lender. The lender would then pick the payments it decided should be made, and would then advance the hospital funds to pay those bills.

As the situation worsened, the hospital began to pay only the "most urgent" bills—and the payroll taxes were not on the "most urgent" list of bills the lender was approving for payment.

Eventually (and not surprisingly) the hospital failed when, one would suppose, even "most urgent" bills were not able to be paid. At that point there were $900,000+ of unpaid

The taxpayer argued, as you might expect, that the payment of taxes was "out of his control." Unfortunately neither the IRS nor the Court accepted that view.

The Court found that Mr. Cherne was a responsible party from inception of the hospital, and that he could not delegate that responsibility by entering into the loan arrangement with the lender. Effectively by entering into that arrangement he, effectively, agreed to allow payroll taxes to go unpaid if the lender decided against paying them.

Mr. Cherne, as conveniently documented by his financial statements disclosing the problem with payroll taxes, was aware the taxes were not being paid currently. Nevertheless he continued to participate in the process by which other bills were paid in preference to the trust fund tax liability that was outstanding. The court quips:

> Although the payment of a company's most pressing expenses and debts at any given time arguably constitutes a reasonable, legitimate business practice for an officer of the company attempting to keep the business operating, such a decision nonetheless is clothed with serious consequences for that officer if employee taxes eventually remain unpaid. Put bluntly, Mr. Cherne and other officers of Florence Hospital and its affiliates gambled that, to bridge the critical financial needs of the hospital, it was best to leave taxes, as opposed to other debts unpaid. As things turned out, they lost that bet.

Applying the Ninth Circuit (the relevant circuit for this Idaho case) decision in the *Nakano* case (742 F.3d at 1212) the Court found that the "encumbrance" of the funds was not relevant.

> Here, there was no written "lock box" agreement, but rather, an informal arrangement apparently existed between Florence Hospital and Clearwater that resembled that type of agreement discussed in *In re Premo*, under which the restrictions on the hospital's funds were imposed by the creditor with the promise of additional funding for the fledgling hospital. Florence Hospital, as well as Mr. Cherne through his compliance and cooperation, voluntarily entered into the agreement with Clearwater to obtain additional funding, and continued with the arrangement even when it became clear the funding needed to pay the withholding tax arrearage would not be forthcoming.

Section: 6672
TIGTA Report Recommends IRS Improve Trust Fund Recovery Penalty Assessment and Collection

Citation: "Trust Fund Recovery Penalty Actions Were Not Always Timely or Adequate", Reference Number 2014 30 034, 5/23/14

The Treasury Inspector General for Tax Administration issued a report criticizing the IRS as being ineffective in handling trust fund penalty cases, reducing the funds the IRS should be (in the view of TIGTA) should be collecting. The report, titled "Trust Fund Recovery Penalty Actions Were Not Always Timely or Adequate", Reference Number 2014-30-034 is available at http://www.treasury.gov/tigta/auditreports/2014reports/201430034fr.html.

The report's findings were summarized as follows:

> TFRP actions were not always timely or adequate. Specifically, TIGTA found untimely TFRP actions, expired assessment statutes, unsupported collectibility determinations, and incomplete TFRP investigations associated with installment agreement and currently not collectible cases. TFRP actions were untimely and/or inadequate in 99 of the 265 cases reviewed in a statistically valid sample. For 59 of the 99 cases, the untimely actions averaged more than 500 days to review and process the TFRP assessment.
>
> When TFRP assessments are not made timely, taxpayers' financial ability to pay can decline, thereby decreasing the IRS's chances to collect the trust fund taxes due. In addition, the Government's interest is not protected if potential TFRP assessments are overlooked or missed.
>
> In recent years, the IRS has introduced new TFRP guidance to better control the TFRP process and has achieved some improvement in the average time it takes to complete investigations and assess the TFRP. However, significant untimeliness still exists.

TIGTA recommended the following:

> TIGTA recommended that the IRS emphasize to group managers their responsibilities to monitor TFRP cases and ensure that revenue officers take timely TFRP actions; enhance TFRP communication and training; ensure completion and adequacy of scheduled system improvements and take appropriate actions to implement the changes; and revise TFRP guidance regarding the accuracy of the collectibility determination support and controlling the completion of TFRP investigations when installment agreements or currently not collectible closures are approved.

The reported noted that the IRS agreed with and plans to implement the recommendations.

What this means from a practical perspective is that the IRS will likely start looking to be more aggressive in assessing and collecting trust fund penalties, as well as being aggressive in asserting responsible person status.

Section: 6672
Spouse Who Formed Corporation and Turned Over Control to Other Spouse Still Found Liable for Trust Fund Penalty

Citation: Johnson v. United States, CA4, 2013 TNT 215-13, 11/5/13

A wife's decision to be the technical owner of a corporation due to her husband's prior IRS issues with the trust fund penalty came back to haunt her later when her husband resumed his conduct of failing to pay payroll taxes. In the case of Johnson v. United States, CA4, http://www.ca4.uscourts.gov/Opinions/Published/121739.P.pdf, 2013 TNT 215-13, Mrs. Johnson was held liable for the responsible person penalty for unpaid payroll taxes.

Mr. Johnson had previously run into the trust fund penalty with a non-profit corporation he had run, and eventually had a lien filed against him after the IRS assessed trust fund recovery penalties against him. This lien made it virtually impossible for a corporation tied to Mr. Johnson to borrow funds or lease property.

So Mr. Johnson asked his wife to form a new for profit corporation that would essentially carry on the business. While she was the sole shareholder, she effectively turned over running the enterprise to Mr. Johnson. Mrs. Johnson delegated virtually all authority to Mr. Johnson, including authority to control the corporate funds and control hiring and firing of employees. Mrs. Johnson initially did not actually sign any checks or authorize payments independently, leaving that to Mr. Johnson.

The corporation fell behind in its payroll taxes, but Mrs. Johnson was not aware of the fact until receiving an IRS notice that the corporation had unpaid payroll taxes for 2001-2004. Upon receiving the notice, Mrs. Johnson immediately confronted Mr. Johnson, fired the employee responsible for handling payroll taxes and directed that Mr. Johnson take personal control over and insures that all taxes were promptly paid from this point forward.

While the corporation paid all future taxes, the corporation did not make payments on the unpaid taxes from 2001-2004.

The IRS assessed the responsible person penalty against both Mr. and Mrs. Johnson. Mrs. Johnson argued that she should not be assessed the penalty. The Court and the IRS disagreed.

First, despite her delegation, Mrs. Johnson had the clear legal authority to direct corporate operations and, in fact, exercised that authority once she discovered the unpaid taxes. The Court held that a person in such a position cannot delegate away their responsibility to oversee corporate finances and therefore fail to be a responsible person.

But the penalty requires a showing of a willful failure to pay. The Court commented briefly that Mrs. Johnson's "hands off" policy did not automatically insure she could not be held to have willfully failed to pay over taxes when she had the authority. But the Court also noted that Mrs. Johnson, despite making sure the company paid taxes from the point she learned of the problem forward, did not take steps to insure that the prior unpaid taxes were paid.

In fact, Mrs. Johnson cashed payroll checks made payable to herself following discovering that there existed unpaid payroll taxes. Generally once the responsible person discovers the shortfall, he/she must insure that all unencumbered funds are used to pay the trust fund taxes. Her failure here is, not surprisingly, fatal to a claim that she had not willfully failed to insure the taxes were paid.

Section: 9815
Proposed Regulations Issued on Implementing Hobby Lobby Decisions for Religious Objection to Providing Contraceptive Care by Closely Held Entities

Citation: REG-129786-14, 8/27/14

The Supreme Court issued a ruling holding that non-publicly traded entities that had a religious objection to providing contraceptive coverage could not be required to do so under the ACA in the case of *Burwell v. Hobby Lobby Stores, Inc.*, 134 S. Ct. 2751, (2014).

The IRS has now issued proposed regulations that allow organizations of that sort to "opt out" of providing contraceptive coverage (REG-129786-14). Generally the proposed regulation would expand on the exemption regulations previously provided for religious organizations with an objection to providing such coverage.

The proposed regulations would add the following language:

> The organization is organized and operates as a closely held for-profit entity, as defined in paragraph (a)(4) of this section, and the entity's objection to covering some or all of the contraceptive services on account of its owners' sincerely held religious beliefs is made in accordance with the organization's applicable rules of governance, consistent with state law.

As noted, the organization will need to be able to show a "sincerely held religious belief" and that the objection is made in accordance with the rules of governance consistent with state law.

However, the proposed regulations do not for now contain a definition of an eligible organization, instead reserving that definition and providing a discussion of definitions the agency is thinking of using in the preamble.

The catch is, as noted above, the Supreme Court in the *Hobby Lobby* case specifically pointed out that the organization in question was a closely held entity and not a publicly traded one, and therefore the Religious Freedom Restoration Act of 1993 applied to block the rule. However, as is often the case, the Court didn't deal with the dirty little details of drawing a fine line regarding how to identify such organizations, aside from knowing that Hobby Lobby is such an organization.

In the preamble, the IRS indicates the agency's thinking regarding a definition regarding what other organizations are "like" Hobby Lobby in this regard:

> In light of the Supreme Court's decision, the Departments are proposing for comment two possible approaches to defining a qualifying closely held for-profit entity, although the Departments invite comments on other approaches as well. In common understanding, a closely held corporation – a term often used interchangeably with a "close" or "closed" corporation – is a corporation the stock of which is owned by a small number of persons and for which no active trading market exists. See, for example, American Law Institute, Principles of Corporate Governances section 1.06; Black's Law Dictionary (9th ed. 2009) ("close corporation"); Del. Code Tit. 8, Ch.1, Sub. Ch. 14 ("close corporation"). The examples below are by way of illustration, and the maximum number of shareholders specified in particular examples would not necessarily be borrowed as the standard in this context.
>
> Under the first proposed approach, a qualifying closely held for-profit entity would be an entity where none of the ownership interests in the entity is publicly traded and where the entity has fewer than a specified number of shareholders or owners. There is precedent in other areas of federal law for

limiting the definition of closely held entities in this context to those with a relatively small number of owners. For example, subchapter S treatment under section 1361 of the Code is currently limited to corporations with 100 or fewer shareholders who are generally individuals and has in the past been limited to corporations with 10 or fewer shareholders. Similarly, certain favorable estate tax treatment is limited to businesses with 45 or fewer partners or shareholders under section 6166 of the Code. Under a second, alternative approach, a qualifying closely held entity would be a for profit entity in which the ownership interests are not publicly traded, and in which a specified fraction of the ownership interest is concentrated in a limited and specified number of owners. This approach also has precedent in federal law. For example, certain rules governing the taxation of real estate investment trusts, passive activity losses, and certain income from foreign entities are limited to organizations that are more than 50 percent owned by or for not more than five individuals. See, for example, sections 856(h), 542(a)(2), and 469(j)(1) of the Code and regulations under these sections.

PARTNERSHIP DEVELOPMENTS

Section: 83
Recipient of Nonvested Capital Interest Not Taxable on Undistributed Income Allocable to the Interesst

Citation: Crescent Holdings, LLC v. Commissioner, 141 TC No. 15, 12/2/13

In the case of *Crescent Holdings, LLC v. Commissioner*, 141 TC No. 15, http://www.ustaxcourt.gov/InOpHistoric/CrescentHoldingsDiv.Ruwe.TC.WPD.pdf, the status of an individual as a partner of the partnership was in question.

In the case in question an individual became CEO of a partnership. Part of the agreement he signed stated that he would be given a 2% interest in the partnership, but that such an interest would vest only if he remained with the entity for three years. The CEO did not execute a §83(b) election to ignore any restrictions on the interest.

Each year the partnership allocated 2% of its profits to the CEO despite the fact that his interest was not vested. The CEO received no distributions during this time.

The opinion notes that the CEO:

> …was surprised he received a Schedule K-1 that allocated income to him because he believed he was not a partner since his interest had not yet vested. Petitioner spoke with Wayne McGee, who was then the chief financial officer of Crescent Resources. Wayne McGee told petitioner that he was not a partner but noted that Crescent Holdings had already filed Schedules K-1 and Morgan Stanley did not want to have to file amended Schedules K-1 for all of the partner investors in MSREF. Petitioner was told that the matter would be corrected for the next tax year. As a result, petitioner reported the Schedule K-1 items on his 2006 Federal income tax return, believing that the matter would be taken care of for the next year.

However, the next year another K-1 appeared in the CEO's mailbox. The Court continues:

> Petitioner was shocked to receive another Schedule K-1 because he believed that Wayne McGee had indicated he would not receive a Schedule K-1 for 2007. Petitioner spoke with Kevin Lambert, who was then the chief financial officer of Crescent Resources. Kevin Lambert then spoke with the accounting firm that had prepared the Form 1065 and Schedules K-1 for Crescent Holdings. Kevin Lambert told petitioner that the accounting firm believed the economic substance of the transaction indicated that petitioner was a partner. Petitioner was upset but wanted to avoid tax penalties for not properly reporting his income, so he reported the Schedule K-1 items on his 2007 Federal income tax return.

Obviously this was creating issues for the CEO, and the Court continues the narrative:

> Petitioner was unhappy with these substantial out-of-pocket expenses and spoke with the management of Duke Ventures and the board of Crescent Holdings. An agreement was reached whereby Crescent Resources paid $1,900,040 to petitioner on July 16, 2008, to cover the tax he paid on the income allocations for the 2006 and 2007 taxable years. On January 13, 2009, Crescent Resources paid $524,500 to petitioner to cover his estimated tax for the 2008 taxable year.

The finances of the entity deteriorated and it prepared for a bankruptcy filing. The CEO resigned his position at this point, before the three year period for vesting was ended, forfeiting the interest.

Eventually the creditors intervened in the proceedings intervened and sought to recover the payments made to the CEO for his taxes. The CEO and creditors agreed that he would repay them after receiving a refund of taxes from amended returns he would file. Thus, this filing set up the case, as the partnership and other partners objected to the amendment which would transfer the income reported by the CEO onto the returns of the other partners.

So, in the final analysis, the parties truly in dispute in this matter are the creditors and the other partners, with the IRS and former CEO primarily involved as "conduits" of sorts—if the CEO wasn't a partner, the IRS sends the money via the ex-CEO to the creditors and the former partners will be sending money to the IRS, while if the CEO was a partner the creditors end with additional cash and the other partners won't have to pay additional tax to the IRS. The IRS has the next most significant interest, since the ruling would have an impact on other similar awards of partnership interests.

The ex-CEO (and, indirectly, the creditors) argued that the interest was covered by IRC §83 since it was an unvested interest, and he would not be the owner under Reg. §1.83-1(a)(1). Under this theory, the CEO should never have been allocated income and, thus, his claims for refunds should be allowed and the remaining partners required to pick up the income that had been allocated to him.

The partnership, on behalf of the remaining partners, argued that §83 did not govern this transaction. Rather, the ex-CEO had a profits interest during the period in question and, as such, under Rev. Proc. 93-27 he should be allocated the income. Under this theory, the ex-CEO's refund claim would be denied and the creditors would not be paid.

The IRS basically agrees with the ex-CEO—the agency argues that the interest in question was a capital interest, thus Rev. Proc. 93-27 does not apply. Nor, as well, was Rev. Proc. 2001-43 applicable in this case. The proper tax treatment would be, as the CEO suggests, to treat the interest as not owned by the ex-CEO due to the application of Reg. §1.83-1(a)(1).

The partnership also offered a backup position in case the court didn't accept the profits interest theory—in that case, the partnership argued that Reg. §1.721-1(b)(1) governed and made the CEO the owner of the interest.

The Court first deals with the Reg. 1.721-1(b)(1) argument. The Court notes that unlike §83, Reg. §1.721-1(b) does not explicitly deal with the question of whether an interest is vested.

Rev. Proc. 2001-43 was issued to clarify Rev. Proc. 93-27 in certain cases. Specifically the ruling dealt with vesting and the determination of a profits or capital interest if the interest is not vested at the time it is granted. The ruling states:

> This revenue procedure clarifies that, for purposes of Rev. Proc. 93-27, where a partnership grants an interest in the partnership that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of its grant, provided that:
>
> > .01 The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;
> >
> > .02 Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and

.03 All other conditions of Rev. Proc. 93-27 are satisfied.

Some treatises have suggested the ruling indicates that a service partner who receives a nonvested interest is treated as a partner upon grant of the interest.

After looking at details of the agreement the Court determined that the interest in question was a capital interest and not a profits interest as the partnership argued under their main contention. Thus the Court had to address the treatment of a nonvested capital interest.

The Court analyzed a number of cases, noting that it had previously treated partnership capital interests as being governed by §83. The partnership did not address these cases, but argued instead that Reg. §1.83-1(a)(1) and Reg. §1.721-1(b)(1) are in conflict.

The partnership then tries to resolve this "conflict" by arguing that the legislative history to §83 never mentioned partnership interest. The Tax Court notes it does not have to, since §83(a) specifically notes it applies to a transfer of property in exchange for services. Regardless of what such history may show, it cannot overcome the actual language of the section in question.

At this point the Court goes on to apply Reg. §1.83-1(a)(1), which provides "any income from such property received by the employee or independent contractor (or beneficiary thereof) or the right to the use of such property by the employee or independent contractor constitutes additional compensation and shall be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available."

The Court goes on to note:

> In addition to the dichotomy created by section 1.83-1(a)(1), Income Tax Regs., between property and income received by the transferee, there exists another stream of potential income recognition—income attributable to property (such as a partnership interest) but not actually distributed. Section 83 does not specifically address whether recognition of undistributed income attributable to the property is also deferred. Similarly, section 1.83-1(a)(1), Income Tax Regs., does not address whether income attributable to the property, but not actually received by the transferee, is included in the gross income of the transferee or the transferor. Particular to this case, section 1.83-1(a)(1), Income Tax Regs., is silent as to whether the distributive share of partnership income attributable to the nonvested 2% partnership interest is included in the income of the transferor or the transferee (petitioner).

The Court found that the question was one of "first impression" which it would need to deal with in this case. The Court found that the transferor (the identity of which was in dispute between the IRS and the partnership) would need to recognize any undistributed partnership profit or loss allocations attributable to the transferees' (the ex-CEO's) unvested capital interest.

The Court notes first that the purpose of §83 is to defer recognition of income subject to a substantial risk of forfeiture:

> Petitioner's right to receive the undistributed income allocations attributable to the 2% interest was subject to the same substantial risk of forfeiture as his right to the 2% interest. If petitioner forfeited his right to the 2% interest, then he would also forfeit his right to receive any benefit from the undistributed income allocations. In other words, petitioner's right to eventually receive any benefit from the undistributed income allocations was entirely dependent on whether his right vested in the 2% interest. When petitioner resigned from his position with Crescent Resources, he forfeited his

right to the 2% interest, which resulted in him losing any rights he would have had to the undistributed income attributable to the 2% interest.

The court notes that if he had remained employed, he would have recognized income equal to the value at the date of vesting of the interest, a value that would have been larger due to the undistributed profits.

The Court also found that Reg. §1.83-1(a)(1) does not actually conflict with Reg. §1.721-1(b)(1). The Court notes that the regulations under §721 are silent with regard to who is the owner of an unvested interest—thus it does not conflict with §83's holding that the individual is not the owner of the property, since §721 and the regulations under that section take no position on the issue.

Thus, the income goes to the transferor. The IRS and partnership disagreed about whether, under the terms of the agreement with the ex-CEO, the partnership or its majority partner was the transferor. The Court, looking at the agreement in question, decided that the partnership as a whole had been designated the transferor.

Section: 108
Debt Secured by Interest in SMLLC That Itself Holds a Single Piece of Real Estate Can Be Treated as Secured by Real Estate for Qualified Real Property Indebtedness Exclusion

Citation: Revenue Procedure 2014-20, 2/5/14

In Revenue Procedure 2014-20 (http://www.irs.gov/pub/irs-drop/rp-14-20.pdf) a safe harbor is provided under which a debt secured by an interest in a single member LLC operating as a disregarded entity holding real estate will be treated as debt secured by real estate for purposes of the qualified real property indebtedness exclusion under IRC §108(c)(3)(A).

Under IRC §108 a taxpayer (other than a C corporation) who receives a discharge of otherwise qualified indebtedness secured by real property used in a trade or business may elect to exclude from income cancellation of debt income from such debt subject to certain limitations. However, today many lenders strongly suggest or require that commercial property be acquired by a single purpose single member LLC whose interests are held by the taxpayer, and that the debt is the secured by that SMLLC. Such structures are used to "isolate" title on the property away from either the mortgage or the property owner, generally out of concern for the possible existence of unknown environmental issues related to the property.

The IRS has in certain cases allowed such debts to be treated as if they were secured by the underlying real property where the entity elects to be treated as a disregarded entity—see Revenue Procedure 2003-65 dealing with interest on real estate mortgages for REITs.

The new ruling outlines situations where the debt will be treated as secured by real property for purposes of qualifying the debt for the qualified real property debt COD exclusion. Such debt will be treated as secured by the real estate if all of the following conditions are met:

- The taxpayer or a wholly owned disregarded entity of the taxpayer ("Borrower") incurs indebtedness;
- Borrower directly or indirectly owns 100% of the ownership interest in a separate disregarded entity owning real property ("Property Owner"). Borrower is not the same entity as Property Owner;
- Borrower pledges to the lender a first priority security interest in Borrower's ownership interest in Property Owner. Any further encumbrance on the pledged ownership interest must be subordinate to the lender's security interest in Property Owner;

- At least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by Property Owner must be real property used in a trade or business and any other assets held by Property Owner must be incidental to Property Owner's acquisition, ownership, and operation of the real property; and
- Upon default and foreclosure on the indebtedness, the lender will replace Borrower as the sole member of Property Owner.

This revenue procedure is effective for taxpayers who make an election under §108(c)(3) for qualified indebtedness discharge on or after February 5, 2014.

Section: 108
CPA Discovers Failure to Make Election When Getting Ready fo Examination--And IRS Still Grants Relief

Citation: PLR 201408007, 2/21/14

The IRS granted a taxpayer's request for relief to make a late election to reduce the basis of assets first rather than the taxpayer's net operating loss under IRC §108(b)(5) in PLR 201408007 (http://www.irs.gov/pub/irs-wd/1408007.pdf). What's interesting is that the CPA who prepared the return (and failed to include the election) discovered the failure while preparing for an IRS examination of the return in question.

Under IRC §108(a)(1)(B) a taxpayer that incurs cancellation of debt income generally excludes that amount from income to the extent the taxpayer is insolvent at the time of the debt discharge. But when the law gives a benefit it often extracts a cost. Generally a taxpayer excluding cancellation of debt income must reduce the basis of various tax attributes, including net operating loss carryovers and basis of assets, up to the amount of income exclusion.

The law provides for a specific ordering of the reductions and, by default, net operating losses are the first attribute to be reduced. However a taxpayer may elect (using Form 982 and on the taxpayer's timely filed federal income tax return) under IRC §108(b)(5) to first reduce the basis of depreciable property. In this case doing so would have been beneficial to the taxpayer.

In this case the taxpayer received notice that the return for the year of debt discharge was being examined. The CPA, while preparing to begin work on the examination, discovered that the election had not been made on Form 982, nor had the portion of the form related to basis reduction been filled out. Upon discovery of the omission the request for a private ruling was filed.

The CPA admitted in affidavit that he had failed to complete Part II of Form 982 and failed to advise the taxpayer to make the election on line 5 of Part II to reduce the basis of depreciable assets first—in essence, "falling on his sword" on this issue.

Despite the fact that the IRS had commenced the examination process, the IRS granted the taxpayer the right to make the late election.

What are the take-aways from this ruling? Most likely it was crucial that the CPA and taxpayer acted before the IRS agent raised the issue. While the facts do not indicate the agent had not raised the issue, the facts indicate that the CPA and taxpayer discovered the problem while preparing for the examination, suggesting strongly that they uncovered the problem without specific prompting from the agent.

To this author it seems unlikely that the IRS would have been so "understanding" if the CPA and taxpayer had waited to see if the agent would catch the issue, a position many clients might initially suggest as the best response. Note that going down that path has additional risks for the CPA beyond simply the fact that there will likely not be an option for relief once the agent uncovers the issue. While the CPA acts as an advocate for the client in an examination, the CPA cannot lie to the agent—but in an attempt to keep the agent from stumbling on the issue, the CPA may end up in a position of "stretching the truth" in various areas or, at the least, misleading the agent.

As well, it's important to note that the CPA "fessed up" to the error to the client. While the ruling indicates the taxpayer and the CPA discovered the error, reality is that most clients are not going to be able to comprehend Part II of Form 982, nor understand the import of that election box.

IRS Director of OPR Karen Hawkins has commented on a number of occasions about her concerns with preparers who discover errors in prepared returns during the examination process. Certainly one concern is that preparers may be tempted to not only hope the IRS won't notice the problem, but figure what the client doesn't know won't hurt the client. Of course the driving force behind keeping the information from the client is to hide the error from both parties.

In any event, a CPA who uncovers such a problem should understand that a conflict of interest is arising at this point, since the interests of the CPA and client are at odds in the matter. CPAs should advise the client to seek independent counsel regarding the proper response and the CPA should seek his/her own counsel on the issue.

In this case the taxpayer did have to agree to extend the statute of limitations on the return in question as a condition for obtaining relief, so it isn't necessarily a completely painless solution. While the extension time isn't totally clear, the fact that the statute was extended until October 9, 2014 certainly makes it reasonable to wonder if that wasn't a one year extension (since many returns on extension are filed at that point in October).

Finally, if that is the case (it was a return that was completed in early October) it also serves as a warning about the need to exercise extra vigilance when preparing those "last minute" returns. Likely this was truly a simple oversight where, for instance, the preparing of Part II of Form 982 was being left until the return was finalized. Of course, in the final push to finish up those last minute extended returns, taking those sorts of extra (and somewhat unusual) steps are just the sort of thing to be missed.

Section: 108
Final Regulations on Treatment of §108(i) Debt Issues for S Corporations and Partnership Issued by IRS

Citation: TD 9623, 7/3/13

The IRS issued final regulations outlining the application of the §108(i) cancellation of debt income deferral provisions as they apply to partnerships and S corporations.

Unlike C corporations where the rules apply to all debt, for a partnership or S corporation the rule only applies to what is referred to as an "applicable debt instrument." An "applicable debt instrument" generally is a debt instrument issued by the partnership or S corporation in connection with the conduct of a trade or business. While the regulations hold that this determination is based on all facts and circumstances, five safe harbor tests are provided where the debt will be treated as issued in connection with the conduct of a trade or business. Meeting any of the five tests will cause the debt to be treated as an "applicable debt instrument."

1. At the date of issuance of the debt instrument, the gross fair value of the trade or business assets of the entity represented at least 80% of the gross fair value of the entity's total assets;

2. For the taxable year of issuance, the trade or business expenditures of the entity represented at least 80% of the entity's total expenditures for the year in question;

3. For the year of issuance at least 95% of the proceeds of debt instruments are traceable to trade or business assets under the interest tracing rules of §1.163-8T;

4. At least 95% of the proceeds from the debt instrument were used by the entity to acquire one or more trades or businesses within 6 months of the date the debt was issued; or

5. The entity issued the debt instrument to a seller of the trade or business to acquire the trade or business. [Reg. §1.108(i)-2(d)(1)]

While COD income must be allocated in accordance with the standard §704 rules for a partnership, after the amount has been allocated among the partners, the partnership can designate what portion of each partner's COD income is subject to the election and which portion is not. [Reg. §1.108-2(b)(1)] For an S corporation, the COD income is shared prorata among the shareholders that are shareholders immediately before the reacquisition of the debt. [Reg. §1.108-2(c)(1)]

Basis generally is not adjusted for either a partner nor an S corporation shareholder on the deferred COD income until the income is taken into income by either the partner or shareholder. However, for purposes of §752 special rules apply, and for purposes of capital account maintenance deferred items are treated as if no §108(i) election had been made.

There are rules in the regulation to prevent the election under §108(i) from triggering recapture of losses under §465(e). The decrease in amount at risk is not taken into account until such time as the amount is recognized in income by the partner or shareholder.

Acceleration events are addressed in the regulations. These are events that trigger the early recognition of the COD income. There are separate triggers that can apply to the entity as a whole, or those that apply to individual partners or shareholders.

The following events at the entity level would trigger an acceleration event for all direct and indirect interest holders: 1) liquidation of the entity, 2) sale, exchange, transfers or gifts of substantially all of the entity's assets, 3) cessation of business by the entity or 4) filing a petition in a bankruptcy or similar case. As well, for an S corporation the termination of the S election is an acceleration event under the regulations.

The term “substantially all of the entity's assets” is defined to mean assets representing at least 90% of the fair value of the entity's net assets and at least 70% of the fair value of the entity's gross assets. Special rules are provided for partnership transfers subject to §721 where subsequent transactions result in dispositions.

At the individual partner level, the following items will be treated as acceleration events: 1) death or liquidation of the partner, 2) sale, exchange, transfer or gift of all or a portion of the partners' interest, 3) redemption of the partner's interest or 4) abandonment of the partner's interest. Events 1, 2 or 4 in the context of an S corporation will cause an S corporation shareholder to have an acceleration event.

If only a portion of an interest is sold, exchanged, transfers or gifted, only a proportionate amount of the COD deferral is triggered.

Certain events are not treated as acceleration events. Transfers under §721 (tax free contributions to a partnership) are generally excluded, as are like kind exchanges under §1031 though for the latter the receipt of boot will be considered in determining what proportion of assets were sold. Technical terminations of a partnership under §708(b) are also not treated as acceleration events.

The regulations apply to applicable debt instruments reacquired in taxable years ending after December 31, 2008.

Section: 453
Hot Asset Gain from Receivables not Eligible for Installment Sale Treatment When Partnership Interest Sold

Citation: Mingo v. Commissioner, CA5, 2014 TNT 238-15, 12/9/14 affirming T.C. Memo. 2013-149, 6/12/13

Another tax case has emerged from the transactions that took place in the early 2000's as consulting arms of various international accounting firms were transferred out of the accounting firm. This case involved the transfer of the consulting and IT portion of PricewaterhouseCoopers (PwC) to IBM and, as with the other cases, involves the tax treatment of the consulting partner.

The case of *Mingo v. Commissioner*, CA5, 2014 TNT 238-15, *affirming* T.C. Memo. 2013-149 involved a number of issues—whether Ms. Mingo had to recognize a portion of the gain on the disposal of her interest as ordinary income under the "hot asset" rules of §751, if so could she report that gain on the installment basis, and whether reporting the ordinary gain on the installment basis (presuming that was erroneous) was an accounting method so that the IRS could require her to pick up the gain in 2003 (since the original year, 2002, was no longer open for tax assessments.

In 2002 PwC disposed of its consulting and IT practice by first creating a new partnership to hold the operation. It then distributed interests in that partnership, along with cash, to the consulting partners. PwC then sold its remaining interest in the "new" (and to be short lived) consulting partnership to IBM. IBM also issued notes to the consulting partners for their interests in that same short lived partnership. The notes eventually could be converted to shares of IBM stock, which Ms. Mingo did in 2007.

Ms. Mingo reported no taxable gain in 2002 on the exchange of her interests in the consulting partnership for the IBM notes. Rather she reported the transaction as an installment sale, showing all of the resulting gain as capital on her Form 6252. In 2007 when she converted her shares to IBM stock, she reported a capital gain of just under $1 million.

In 2006 the IRS notified Ms. Mingo that the agency would be examining her 2003 tax return, the return for the year after the sale transaction. At this time the statute of limitations on assessing tax on her 2002 return had expired.

The IRS determined that Ms. Mingo should have recognized an ordinary gain from the disposal of her interest in the partnership related to her share of the unrealized receivables in the partnership at the time she received the installment notes from IBM. Those receivables amounted to $126,240.

The IRS also argued that this gain did not qualify for installment sale treatment. Of course, that meant that the gain should have been reported in 2002, a year that the IRS could no longer assess a deficiency against. So the IRS also argued that her treatment of the gain as eligible for the installment basis of accounting was an accounting method that failed to clearly reflect income. The IRS could therefore require her to change her accounting method in 2003, making use of §481(a) at that point to require her to pick the ordinary income in that year, a year that was open for assessment.

The taxpayers did not dispute that the amount in question was subject to the hot asset rules by the time the case went to trial. However, they did dispute the IRS's contention that the gain was not eligible for installment sale treatment.

The Tax Court held, and the appellate panel concurred, that such a hot asset gain related to receivables was not eligible for installment sale treatment. The Tax Court stated:

> In *Sorensen v. Commissioner*, 22 T.C. 321 (1954), a taxpayer was given several options to purchase stock as compensation for his services. He sold these options rather than exercising them and attempted to report his gain under section 44(b), I.R.C. 1939, the predecessor to section 453. The Court held that the installment sale provisions did not apply to the sale because "[t]he provisions of section 44 relate only to the reporting of income arising from the sale of property on the installment basis. Those provisions do not in anywise purport to relate to the reporting of income arising by way of compensation for services." *Sorensen v. Commissioner*, 22 T.C. at 342.
>
> The reasoning of the Court in Sorensen still holds true. Nothing in section 453 or its associated legislative history suggests that Congress intended to allow taxpayers to escape the basic principles of revenue recognition by deferring compensation for services under the installment method. Petitioners do not dispute that $126,240 of the $823,090 face value of the note was attributable to unrealized receivables of the PwCC partnership. As illustrated above, those unrealized receivables, if sold in a direct sale, would not be eligible for installment method reporting under section 453. Accordingly, the gain realized on Mrs. Mingo's partnership interest, to the extent attributable to partnership unrealized receivables, was likewise ineligible for installment method reporting under section 453. Petitioners should have properly reported an additional $126,240 of ordinary income on their 2002 Federal income tax return instead of reporting it under the installment method.

Accepting that view, the taxpayers disputed that their treatment amounted to a method of accounting. If this was simply an error and not an accounting method, the IRS would have a hollow victory—the income would fall into a year into which the IRS was unable to assess tax.

A method of accounting under §446 generally is something that affects the *timing* of income or deduction recognition, but not the *amount* of the item. However, a method of accounting is not generally established for a taxpayer until the taxpayer shows a consistent pattern of using the method.

The IRS has broad discretion to require a taxpayer to change a method of accounting if it fails to clearly reflect income.

The IRS argued, and the courts agreed, that the Mingos had attempted to report the entire gain on the installment basis. The amount of gain would not have been changed by taxing the gain on the installment basis, rather simply the timing of the reporting of such gain.

As the Fifth Circuit opinion noted:

> By initially electing to use the installment method in 2002, Mingo would have had no reason to believe that she had escaped taxation on the $126,240 gained from the unrealized receivables. *See Graff v. Chevrolet Co. v. Campbell*, 343 F.2d 568, 572 (5th Cir. 1965) ("When a taxpayer uses an accounting method which reflects an expense before it is proper to do so or which defers an item of income that should be reported currently, he has not succeeded (and does not purport to have succeeded) in permanently avoiding the reporting of any income; he has impliedly promised to report that income at a later date, when his accounting method, improper though it may be, would require it."). Instead, she had merely deferred taxation on the unrealized receivables until 2007. The Commissioner did not abuse his discretion by forcing Mingo to report the amount as taxable income in 2003 as opposed to 2007 in light of the Commissioner's correct determination that Mingo's use of the installment method was improper.

As for the consistent reporting, the Tax Court opinion noted:

> Although a method of accounting may exist without the necessity of a pattern of consistent treatment of an item, in most instances an accounting method is not established for an item without such consistent treatment. Id. Petitioners elected to report the sale of Mrs. Mingo's partnership interest on the installment method by attaching a Form 6252 to their joint 2002 Federal income tax return. For tax years 2003 through 2006 petitioners filed tax returns reflecting only interest income from the note. In tax year 2007 petitioners reported the proceeds from the sale when Mrs. Mingo converted the note into IBM stock as would typically be proper under the installment method of reporting income. Therefore, petitioners established a pattern of consistent treatment under the installment method of reporting for this material item.

The fact the item is a method accounting allows the IRS to avoid the problem of the "closed" year. As the Tax Court noted:

> Section 481(a) provides that in computing a taxpayer's taxable income after a change of accounting method has occurred, there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. A section 481(a) adjustment may include amounts attributable to tax years outside the period of limitations on assessment. *Bosamia v. Commissioner*, 661 F.3d 250, 257-258 (5th Cir. 2011), aff'g T.C. Memo. 2010-218. Respondent made a section 481(a) adjustment of $126,240 for tax year 2003, the year for which respondent initiated the change of accounting method. This adjustment was necessary to remedy the omission of ordinary income that occurred for tax year 2002 as a result of petitioners' impermissible election to use the installment method. Accordingly, respondent's determination that petitioners had additional ordinary income of $126,240 for tax year 2003 is sustained.

Section: 465
Impact of LLC Member Guaranteeing Debt on Guarantor and Other Members Outlined by IRS

Citation: AM-2014-003, 4/4/14

In Legal Advice AM-2014-003 (http://www.irs.gov/file_source/pub/irs-utl/AM2014-003.pdf) the IRS outlines the impact on amount at risk when an LLC member guarantees the debt of the LLC. The memorandum considers the following:

- A guarantee of the debt of an LLC treated as a partnership or disregarded entity
- The impact if that debt is otherwise qualified nonrecourse financing under IRC §465(b)(6)(B)

The "at risk" rules under §465 were one of Congress's many attempts to rein in the pre-Tax Reform Act of 1986 tax shelter industry, one that actually didn't manage to stop the shelters (that took the passive loss rules that came with the 1986 Act). However the rules have remained in the IRC, and taxpayers can still trip over them and they sometimes have unusual consequences.

Generally the idea of the at risk rules was to limit the amount that a taxpayer could deduct from an activity to the amounts that the taxpayer truly might lose out of pocket. However a special exception was written into the rules for real estate (the qualified nonrecourse debt rules) under which taxpayers are able to continue to claim losses even when the lender has no recourse against any investor.

With regard to the issue of what happens to the individual who guarantees the debt of the LLC, the memo first explains why, in a limited partnership, this generally would not increase the amount at risk. While a limited partner that guarantees the debt of the limited partnership may find the lender getting its "pound of flesh" (that is, cash) from the partner, that limited partner would, as a guarantor, have a right of reimbursement from both the partnership (the entity that owed the debt) and the general partner (the party generally liable on partnership debt).

A right of reimbursement is protection against loss--and thus, takes away the "risk" (at least in theory) that the taxpayer would truly end up worse off. Thus, in this case, the taxpayer's amount at risk would not go up despite the guarantee.

However the memo notes that an LLC is different. In that case no member is in a similar position to a general partner--that is, someone with inherent liability for the entity's debts. Thus an LLC member guaranteeing the debt of the entity by him/herself would not generally have a right of reimbursement except against the LLC itself.

But what about that right from the LLC? The memo, consistent with the position outlined in the 2013 Chief Counsel Advice 201308028, rules that does not reduce the amount at risk. If there is a right of reimbursement from an outsider (such as another member), then *that* would serve to reduce the amount at risk.

The memo goes on to note, though, that such a guarantee of what was qualified nonrecourse debt will remove the debt from that category. While the guarantor is now deemed at risk for the entire debt (since he/she has given the lender the right to come after him/her for any shortfall), the other members will now see a decrease in the amount at risk, since the debt will no longer be qualified nonrecourse financing.

Thus, in that case, those other members may have to recapture prior losses that have been claimed if the reduction pushes their at risk amount below zero.

Section: 701
Safe Harbor Structure for Partnerships Allocating Rehabilation Credits Provided by IRS

Citation: Revenue Procedure 2014-12, 11/24/14

The IRS's victory in the case of *Historic Boardwalk Hall, LLC. v. Commissioner*, 694 F.3d 425 (3d Cir. 2012), *cert. denied* told us what type of allocation of rehabilitation credits and partnership structure would not be held to be valid for IRC purposes. However, that leaves open the question of what types of allocation of credits and partnership structure would be acceptable for these purposes.

In response to such concerns, the IRS has issued Revenue Procedure 2014-12 which provides a safe harbor structure where the IRS will not raise a challenge similar to that it raised in *Historic Boardwalk* that the members allocated the credits were not truly partners in a partnership. The IRS notes that satisfying the safe harbor does not mean the IRS will not challenge the validity of the underlying claim of the credit, nor should this ruling be read to provide a safe harbor for other partnership credits.

The following (among other details described in the Revenue Procedure) must be satisfied to come within the safe harbor:

- Principals (that is, those authorized to act on behalf of the partnership) must have a minimum 1% interest in all items of partnership income, gain, loss, deduction and credit at all times
- An investor's (a non-principal) partnership interest must satisfy the following requirements:

- Minimum Interest – "The Investor must have, at all times during the period it owns an interest in the Partnership, a minimum interest in each material item of Partnership income, gain, loss, deduction, and credit equal to at least five percent of the Investor's percentage interest in each such item for the taxable year for which the Investor's percentage share of that item is the largest (as adjusted for sales, redemptions, or dilution of the Investor's interest)."
- Bona Fide Interest – The interest must be a bona fide interest in the partnership. The ruling provides:
    - An Investor's Partnership interest is a bona fide equity investment only if that reasonably anticipated value is contingent upon the Partnership's net income, gain, and loss, and is not substantially fixed in amount.
    - The Investor must not be substantially protected from losses from the Partnership's activities.
    - The Investor must participate in the profits from the Partnership's activities in a manner that is not limited to a preferred return that is in the nature of a payment for capital.
- No arrangements to reduce the value of the Investor's interest. Such arrangements include:
    - Fees (including developer, management, and incentive fees), lease terms, or other arrangements that are unreasonable as compared to fees, lease terms, or other arrangements for a real estate development project that does not qualify for § 47 rehabilitation credits;
    - Disproportionate rights to distributions or by issuances of interests in the Partnership (or rights to acquire interests in the Partnership) for less than fair market value consideration;
    - A sublease agreement of the Building from the Master Tenant Partnership back to the Developer Partnership or to the Principal of either the Developer Partnership or Master Tenant Partnership (unless the sublease is mandated by a third party unrelated to the Principal);
    - A sublease agreement of the Building by the Master Tenant Partnership to any person unless the duration of the sublease is shorter than the duration of the Head Lease; and
    - Termination of its lease of the Building by the Master Tenant Partnership from the Developer Partnership during the period in which the Investor remains as a partner in the Master Tenant Partnership.
- Investor's Minimum Contribution – The investor must make a minimum contribution of 20% of the investor's expected capital contribution to the partnership prior to the date the building is placed in service.
    - The investor must maintain the minimum contribution throughout the entire period the investor owns the partnership interest
    - The investor may not be protected against loss, directly or indirectly, by any person involved with the rehabilitation except as permitted under this Revenue Procedure (see guarantees below)
    - Contributions of promissory notes or similar items will not be counted towards the minimum contribution

    - Contingent Consideration – at least 75% of the investor's total capital contributions must be fixed in amount before the building is placed in service and the investor must reasonably expect to be able to meet his/her funding obligations as they come due.
- Guarantees and Loans
    - Permissible <u>unfunded</u> guarantees to the investor include:
        - Performance of acts necessary to claim the §47 rehabilitation credit and avoidance of acts that would disqualify the right to claim the credit
        - Any other unfunded guarantee not listed as a prohibited guarantee
        - Acceptable guarantees, so long as unfunded, include completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants.
    - Impermissible guarantees
        - No person involved in any part of the rehabilitation transaction may directly or indirectly guarantee or otherwise insure the Investor's ability to claim the § 47 rehabilitation credits, the cash equivalent of the credits, or the repayment of any portion of the Investor's contribution due to inability to claim the § 47 rehabilitation credits in the event the Service challenges all or a portion of the transactional structure of the Partnership;
        - No person involved in any part of the rehabilitation transaction may guarantee that the Investor will receive Partnership distributions or consideration in exchange for its Partnership interest (except for a fair market value sale right described in section 4.06(2) of the Revenue Procedure);
        - No person involved in any part of the rehabilitation transaction may pay the Investor's costs or indemnify the Investor for the Investor's costs if the Service challenges the Investor's claim of the § 47 rehabilitation credits;
        - No funded guarantees
    - Loans – "A Developer Partnership, a Master Tenant Partnership, or the Principal of either the Developer Partnership or the Master Tenant Partnership may not lend any Investor the funds to acquire any part of the Investor's interest in the Partnership or guarantee or otherwise insure any indebtedness incurred or created in connection with the Investor's acquisition of its Partnership interest."
- Purchase and Sale Rights
    - Neither a Principal nor the Partnership may have a call right (or similar right or agreement) to purchase or redeem the Investor's interest at a future date (other than a contractual right for a present sale);
    - Similarly, the Investor cannot have a put right to require any person involved in the rehabilitation to acquire the Investor's interest
    - Any determination of the fair value of the Investor's interest must include only those contracts or obligations that meet the requirements about not reducing the value of the Investor's interest
    - An investor may not acquire his/her interest with the intent to abandon the interest once the rehabilitation is complete

The credit must be allocated in accordance with the provisions of IRC §704(b), specifically the provisions found at Reg. § 1.704-1(b)(4)(ii) on allocation of credits that require they be in accordance with the partners' interest in the partnership at the time the credit arises.

The Revenue Procedure provides two examples of the application of the procedure.

While officially a "safe harbor" (meaning failing it does not mean you cannot allocate the credit), agents have often viewed a failure to meet a safe harbor as indicating that the taxpayer should experience the "bad result" that the safe harbor was meant to avoid.

Section: 702
Refundable State Tax Credit Received Based on Partnership Investment is Not a Partnership Item, Does Not Create Basis and Is Not a Partnership Distribution

Citation: CCA 201421016, 5/23/14

Income tax credits, including refundable ones, seem to be the tax tool of the moment for state governments. In many cases these refunds are, at least under some circumstances, refundable and, as well, may be passed through to partnership and S corporation equity holders. In Chief Counsel Advice 201421016 (http://bit.ly/CCA1421016) the IRS dealt with just such a credit (the Refundable New York State Investment Tax Credit) for a partner who had exhausted his/her basis and had unused losses and insufficient New York income tax to absorb the entire credit (and thus was getting a cash payment from the state).

The taxpayer had two theories to avoid having to pay tax on the amount of refund as ordinary income.

First, the taxpayer argued that this payment increased his basis in the partnership interest and, as well, was passive income. Therefore while he might have ordinary income, it would be entirely offset by losses carried into the current year.

In the alternative the taxpayer argued this payment should be treated as a distribution from the partnership and, as a distribution in excess of basis, would be taxed as a long term capital gain.

The IRS rejects both arguments for the reasons noted below:

> Central to both of the taxpayer's arguments is that the NYITC refund should be considered a partnership item, or similar in nature to a partnership item. If the NYITC is a partnership item it may increase the taxpayer's outside basis in the partnership interest under § 705(a). In addition, since the refund arises from the trade or business activities of the partnership, the refund amount could be considered a deemed distribution of money to the taxpayer from the partnership under § 731(a)(1).
>
> The NYITC refund is paid directly by New York State to the taxpayer, and the LLC neither receives the refund nor has a right to receive the refund. We do not believe that the partnership owns the NYITC refund and therefore it is not properly treated as a partnership item under § 702. Because the NYITC refund is not properly treated as a partnership item, the NYITC refund cannot affect the taxpayer's outside basis in the partnership under § 705(a).
>
> Similarly, the NYITC refund should not be treated as partnership property for purposes of § 731(a)(1). Accordingly, if the NYITC refund is not properly treated as partnership property, it should not be treated as a deemed distribution in excess of basis from the partnership to the taxpayer.
>
> Therefore, the refundable portion of NYITC should be treated as ordinary income to the taxpayer.

While the answer dealt with a specific New York state tax credit, the same result should be obtained for other refundable credits received from other states.

Section: 708
Final Regulations Clarify that Partnership May Not Write Off Unamortized Start-Up Costs or Partnership Organization Costs Due to a Technical Termination.

Citation: TD 9681, 7/23/14

The IRS issued final regulations (TD 9681, http://www.gpo.gov/fdsys/pkg/FR-2014-07-23/pdf/2014-17335.pdf) regarding technical terminations of a partnership to clarify that a technical termination under IRC §708(b)(1)(B) does not entitle a partnership to deduct unamortized start-up expenses under IRC §195 or partnership organizational expenses under IRC §709.

Some partnerships had taken the position that when a technical termination takes place that the partnership may write off any unamortized start-up costs under IRC §195 and partnership organization expenses under IRC §709.

The regulations make revisions to Regs. §1.195-2, §1.708-1 and §1.709-1.

The rules are effective for a technical termination occurring on or after December 9, 2013.

Section: 723
No Basis for Partners' Own Promissory Notes Contributed to Partnership

Citation: VisionMonitor Software LLC v. Commissioner, TC Memo 2014-182, 9/3/14

Basis in partnerships can be a tricky concept for taxpayers to deal with. In the case of *VisionMonitor Software LLC v. Commissioner*, TC Memo 2014-182 the matter involved whether partners could obtain basis for deducting losses by signing promissory notes to the partnership.

In this case the promissory notes were requested by a "money partner" who was willing to contribute just under a million dollars to help the partnership through its early lean years, but only if the two "non-money" partners put themselves at greater risk. The partnership recorded the amounts on the books as contributed capital and accrued interest due on the notes, but the signors did not fund the notes in the years in question.

In the end the business portion of the story had a happy ending, as the partnership did survive its lean years and has gone on to be profitable. But in 2006 and 2007 the entity was not profitable, and the partners who signed the promissory notes treated those notes as basis for deducting losses on their personal returns.

The IRS argued that since the partners had no basis in the notes there was no addition to the basis of the partners' interests when the notes were contributed, since IRC §723 provides that the basis of the partner is limited to the basis of the property contributed.

The Tax Court, citing a number of prior rulings, agreed with the IRS on this matter. The partners protested by citing the case of *Gefen v. Commissioner*, 87 TC 1471 (1986).

In *Gefen* a partner was required to execute a guarantee of a debt of the partnership as a condition of being admitted to the partnership. She guaranteed her prorata share of an existing partnership debt and agreed that the partnership could call on her to contribute cash to pay her share of the note. The taxpayers argued that their case was similar, since the "money partner" wanted them at risk when that party put in about $1 million.

The Court distinguished the case by pointing out that the partners were not guaranteeing a pre-existing debt of the partnership, nor did they assume any of the partnership's liability. Rather their liability was to the partnership itself.

Although it may not seem "fair," partners do not obtain basis when they contribute their own promissory note until such time as they actually make a payment on the note in question. That's true even when, in a case like this one, another partner is the once forcing the issue.

Section: 751
Proposed Regulations Issued That Would Revise Hot Asset Treatment for Partners

Citation: REG-151416-06, 10/31/14

Proposed regulations have been issued by the IRS (REG-151416-06) that would change the methods used to compute amounts included as income under the "hot asset" rules for partners in a partnership.

The proposed regulations follow generally the methods proposed by the IRS in Notice 2006-14 that initially proposed changing the regulations impacting this situation and asking for comments. The IRS indicated that the comments they received generally were favorable for changing from the "gross value" approach under current regulations with a "hypothetical sale" approach for determining if there has been a change in a partners' share of hot assets and how much income should be recognized.

The preamble to the proposed regulations describes the hypothetical sale approach as follows:

> As described in this preamble, the hypothetical sale approach requires a partnership to compare: (1) the amount of ordinary income (or ordinary loss) that each partner would recognize if the partnership sold its property for fair market value immediately before the distribution with (2) the amount of ordinary income (or ordinary loss) each partner would recognize if the partnership sold its property, and the distributee partner sold the distributed assets, for fair market value immediately after the distribution.

That allocation of income would include allocations required to be made pursuant to IRC §704(c) to the partner in making this determination, as well as taking into account any basis adjustment pursuant to §743, if applicable, to the partner.

The partnership, if it keeps capital accounts, will be required to revalue §704(b) book capital accounts pursuant to Reg. §1.704-1(b)(2)(iv)(f) if it distributes money or property (other than a de minimis amount) to a partner as consideration for his interest when the partnership owns §751 property. If the partnership does not maintain §704(b) capital accounts, the partnership must conform with this requirement by undertaking a deemed sale calculation.

If a partner receiving property triggers a §734(b) basis adjustment (that is, a §754 election is in place), then the distribute partner will be required to recognize a capital gain equal to the amount necessary to remove that §734(b) basis adjustment. If, rather, there is no §734(b) issue but, rather, the partner faces a basis adjustment under §732(a)(2) or (b), the partner may elect to recognize a capital gain in lieu in the amount of the required basis reduction in lieu of reducing basis. A partner making this election must notify the partnership of his intent to make this election and report the capital gain on his return. The regulations specifically provide that no late election relief will be available by asking for a letter ruling under §301.9100-3 even though the election date is set by regulation.

The regulations would also make changes to the regulations under §704(c). First, the preamble notes:

> Because the hypothetical sale approach relies on the principles of section 704(c) to preserve a partner's share of the unrealized gain and loss in the partnership's section 751 property, these proposed regulations make several changes to the regulations relating to section 704(c). Specifically, the proposed regulations revise §1.704-1(b)(2)(iv)(f), regarding revaluations of partnership property, to make its provisions mandatory if a partnership distributes money or other property to a partner as consideration for an interest in the partnership, and the partnership owns section 751 property immediately after the distribution. (A partnership that does not own section 751 property immediately after the distribution may still revalue its property under the existing regulation, but is not required to do so under these proposed regulations.) If a partnership does not maintain capital accounts in accordance with §1.704-1(b)(2)(iv), the partnership must comply with this requirement by computing each partner's share of gain or loss in each partnership asset prior to a distribution, and making future allocations of partnership items in a manner that takes these amounts into account (making subsequent adjustments for cost recovery and other events that affect the property basis of each such asset).

Tiered partnerships would be impacted by the following change to the revaluation rules:

> In addition, the proposed regulations contain a special revaluation rule for distributing partnerships that own an interest in a lower-tier partnership. Because a partnership's section 751 property includes, under section 751(f), the partnership's proportionate share of section 751 property owned by any other partnership in which the distributing partnership is a partner, these proposed regulations also require a partnership in which the distributing partnership owns a controlling interest (which is defined as a greater than 50 percent interest) to revalue its property if the lower-tier partnership owns section 751 property immediately after the distribution. If the distributing partnership owns a non-controlling (that is, less than or equal to 50 percent) interest in a lower-tier partnership, these proposed regulations require the distributing partnership to allocate its distributive share of the lower-tier partnership's items among its partners in a manner that reflects the allocations that would have been made had the lower-tier partnership revalued its partnership property. The IRS and the Treasury Department are aware that in some instances a distributing partnership may be unable to obtain sufficient information to comply with this requirement from a lower-tier partnership in which the distributing partnership holds a non-controlling interest. We request comments on reasonable approaches to address this issue.

The preamble also discusses the options for dealing with §704(c) issues in the case of revaluations in these cases. The preamble notes:

> Upon the revaluation of partnership property in connection with a partnership distribution, the regulations under section 704(c) permit a partnership to choose any reasonable method to account for the built-in gain or built-in loss that is consistent with the purpose of section 704(c). If property with built-in gain decreases in value (or property with built-in loss increases in value), then the partnership may be unable to allocate tax losses (or gains) to a non-contributing partner in an amount equal to the partner's economic loss (or gain). If the property with built-in gain (or loss) is section 751 property, then the inability to allocate those tax losses (or gains) may cause ordinary income to shift among the partners. The regulations under section 704(c) provide two reasonable methods for a partnership to allocate items to cure or remediate that shift. However, the regulations under section 704(c) also provide a third reasonable method, the traditional method, under which the shift of ordinary income is not cured. The IRS and the Treasury Department are aware that distortions

> created under the section 704(c) traditional method may cause ordinary income to shift among partners. However, the regulations under section 704(c) contain an anti-abuse rule that provides that a method is not reasonable if, for example, the event that results in a reverse section 704(c) allocation and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or built-in loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. The IRS and the Treasury Department believe that this anti-abuse provision under section 704(c) properly addresses the possibility that taxpayers would use the traditional method to shift ordinary income.

The proposed regulations would also remove the "deemed asset exchange" that is used to swap hot asset/non-hot asset properties in such a situation, but does not replace it with a mandatory method for computing the hot asset income inclusion. The IRS noted that both a deemed gain and a deemed asset exchange approach may, in certain circumstances, produce superior results.

Thus, the preamble notes:

> [T]hese proposed regulations withdraw the asset exchange approach of the current regulations, but do not require the use of a particular approach for determining the tax consequences of a section 751(b) distribution. Instead, these proposed regulations provide that if, under the hypothetical sale approach, a distribution reduces a partner's interest in the partnership's section 751 property, giving rise to a section 751(b) amount, then the partnership must use a reasonable approach that is consistent with the purpose of section 751(b) to determine the tax consequences of the reduction. Except in limited situations, a partnership must continue to use the same approach, once chosen, including after a termination of the partnership under section 708(b)(1)(B). These proposed regulations include examples in which the approach adopted is generally reasonable based on the facts of the examples, and one example in which it is determined that the adopted approach is not reasonable based on the facts of the example.

The above is a rough summary of some of the provisions found in this proposed rewrite of the hot asset rules. As well, the IRS is asking for additional comments for other, related areas that would be impacted by any rewrite of these rules.

The regulations provide a series of examples demonstrating how the rules would apply which can be found at Reg. §1.751-1(g). The examples are reproduced below:

Example (1). (i) (A) A and B are equal partners in personal service partnership PRS. A contributed nondepreciable capital assets (the "Capital Assets") to PRS with a basis and fair market value of $14,000. B contributed unrealized receivables described in paragraph (c) of this section (the "Unrealized Receivables") to PRS with a basis of zero and fair market value of $14,000. Later, when the fair market value of the Capital Assets had declined to $2,000, B transferred its interest in PRS to T for $9,000 when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) was as follows:

Assets

	Adjusted Basis	Fair Market Value
Cash	$ 4,000	$ 4,000
Capital Assets	14,000	2,000
Unrealized Receivables	0	14,000
Total	18,000	20,000

Liabilities and Capital

	Adjusted Basis	Fair Market Value
Liabilities	$2,000	$2,000
Capital:		
A	15,000	9,000
B	1,000	9,000
Total	18,000	20,000

(B) The total amount realized by B is $10,000, consisting of the cash received, $9,000, plus $1,000, B's share of the partnership liabilities assumed by T. See section 752. B's interest in the partnership property includes an interest in the partnership's Unrealized Receivables. B's basis in its partnership interest is $2,000 ($1,000, plus $1,000, B's share of partnership liabilities). If section 751(a) did not apply to the sale, B would recognize $8,000 of capital gain from the sale of the interest in PRS. However, section 751(a) does apply to the sale.

(ii) For purposes of section 751(a), the amount of money or the fair market value of property received by the partner in exchange for all or part of his partnership interest must take into account the partner's share of income or gain from section 751 property. If PRS sold all of its section 751 property in a fully taxable transaction immediately prior to the transfer of B's partnership interest to T, B would have been allocated $14,000 of ordinary income from the sale of PRS's Unrealized Receivables under section 704(c). Therefore, B will recognize $14,000 of ordinary income with respect to the Unrealized Receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 ($8,000) and the amount of ordinary income or loss determined under paragraph (a)(2) of this section ($14,000) is the transferor's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a $6,000 capital loss.

Example (2). (i) A, B, and C each contribute $120 to partnership ABC in exchange for a 1/3 interest. A, B, and C each share in the profits and losses of ABC in accordance with their 1/3 interest. ABC purchases land for $100 in Year 1. At the end of Year 3, when ABC holds $260 in cash and land with a value of $100 and has generated $90 in zero-basis unrealized receivables, ABC distributes $50 cash to C in a current distribution, reducing C's interest in ABC from 1/ 3 to 1/4. ABC has a section 754 election in effect. To determine if the distribution is a distribution to which section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii) (A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets and its partners' capital accounts are increased under §1.704-1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	100	100	C	120	150
Totals	360	450		360	450

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately before the distribution, A, B, and C would each be allocated $30 of net income from ABC's section 751 property. Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $30 each under paragraph (b)(2)(ii) of this section.

(iii) (A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Cash	$210	$210	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	100	100	C	70	100
Totals	310	400		310	400

(B) If ABC disposed of all of its assets in exchange for cash in amounts equal to the fair market values of those assets immediately after the distribution, A, B, and C would each still be allocated $30 of net income from ABC's section 751 property pursuant to § 1.704-3(a)(6). C did not receive any section 751 property in the distribution. Accordingly, A, B, and C's net section 751 unrealized gain immediately after the distribution is $30 each under paragraph (b)(2)(iii) of this section.

(iv) Because no partner's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, and because no partner's net section 751 unrealized loss is greater immediately after the distribution than immediately before the distribution, the distribution is not a section 751(b) distribution under paragraph (b)(2)(i) of this section. Accordingly, section 751(b) does not apply to the distribution.

Example (3). (i) Assume the same facts as in Example 2 of this paragraph (g), but assume ABC distributes $150 cash to C in complete liquidation of C's interest. To determine if the distribution is a distribution to which section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii) (A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets and its partners' capital accounts are increased under §1.704-1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	100	100	C	120	150
Totals	360	450		360	450

(B) If ABC disposed of all of its assets in exchange for cash in amounts equal to the fair market values of these assets immediately before the distribution, A, B, and C would each be allocated $30 of net income from ABC's section 751 property. Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $30 each under paragraph (b)(2)(ii) of this section.

(iii) (A) Because ABC has elected under section 754, and because A recognizes $30 gain on the distribution of cash, the basis of the real property is increased to $130 under section 734(b). After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Cash	$110	$110	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	130	100	C	0	0
Totals	240	300		240	300

(B) Because C is no longer a partner in ABC, C would not be allocated any net income from ABC's section 751 property immediately after the distribution. Also, C did not receive any section 751 property in the distribution. Accordingly, C's net section 751 unrealized gain immediately after the distribution is $0 under paragraph (b)(2)(iii) of this section.

(iv) Because C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, section 751(b) applies to the distribution. Under paragraph (b)(2)(i) of this section, C has a section 751(b) amount equal to $30, the amount by which C's share of pre-distribution net section 751 unrealized gain ($30) exceeds C's share of post-distribution net section 751 unrealized gain ($0). Accordingly, paragraph (b)(3)(i) of this section requires C to recognize $30 of ordinary income using a reasonable approach consistent with the purpose of this section. ABC considers two approaches, the first of which is described in paragraphs (v) and (vi) of this example, and the second of which is described in paragraphs (vii) and (viii) of this example.

(v) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, C is deemed to recognize $30 of ordinary income. To reflect C's recognition of $30 of ordinary income, C increases its basis in its ABC partnership interest by $30, and the partnership increases its basis in the unrealized receivable by the $30 of income recognized by C, immediately before the distribution. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the section 751(b) distribution immediately prior to the cash distribution, ABC's modified balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized Receivable	30	90	B	120	150
Real Property	100	100	C	150	150
Totals	390	450		390	450

(vi) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Accordingly, C recognizes no gain or loss under section 731(a) upon the distribution. Because C recognizes no gain on the distribution, the basis of the partnership real property is not adjusted. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$110	$110	A	$120	$150
Unrealized Receivable	30	90	B	120	150
Real Property	100	100	C	0	0
Totals	240	300		240	300

(viii) Assume alternatively that ABC adopts an approach under which, immediately before the section 751(b) distribution, C is deemed to--

(A) Receive a distribution of ABC's unrealized receivables with a fair market value of $30 and a tax basis of $0;

(B) Sell the unrealized receivable to ABC in exchange for $30, recognizing $30 of ordinary income; and

(C) Contribute the $30 to ABC. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the section 751(b) distribution immediately prior to the cash distribution, ABC's modified balance sheet is the same as the balance sheet shown in paragraph (v) of this example.

(viii) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. The tax consequences under the rules of sections 731 through 736 are the same tax consequences described in paragraph (vi) of this example.

Example (4). (i) A and B are equal partners in a partnership, AB, that owns Unrealized Receivable with a fair market value of $50 and nondepreciable real property with a basis of $50 and a fair market value of $100. A has an adjusted basis in its partnership interest of $25, and B has an adjusted basis in its partnership interest of $50. The partnership has a section 754 election in effect, and B has a basis adjustment under section 743(b) of $25 that is allocated to Unrealized Receivable. AB distributes Unrealized Receivable to A in a current distribution. To determine if the distribution is a distribution to which section 751(b) applies, AB must apply the test set forth in paragraph (b)(2) of this section.

(ii) (A) AB makes a non-mandatory revaluation of its assets and its partners' capital accounts are increased under §1.704- 1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, AB's balance sheet is as follows:

	Tax	Basis Adj.	Book	Capital	Tax	Special Basis	Book
Unrealized Receivable	0	25	50	A	25		75
Real Property	50		100	B	25	25	75
Totals	50	25	150		50	25	150

(B) If AB disposed of all of its assets in exchange for cash in amounts equal to the fair market values of these assets immediately before the distribution, A and B would each be allocated $25 of net income from AB's section 751 property. However, B's net income from Unrealized Receivable would be offset by its $25 section 743 adjustment. §1.743-1(j)(3). Accordingly, A and B's net section 751 unrealized gain immediately before the distribution are $25 and $0, respectively, under paragraph (b)(2)(ii) of this section.

(iii) (A) After the distribution (but before taking into account any consequences under this section), AB's balance sheet would be as follows:

	Tax	Basis Adj.	Book	Capital	Tax	Carryover Adjustment	Book
Carryover Adjustment		25	0	A	25		25
Real Property	50		100	B	25	25	75
Totals	50	25	100		50	25	100

(B) If AB disposed of all of its assets in exchange for cash in amounts equal to the fair market values of those assets immediately after the distribution, no partner would be allocated net income or loss from section 751 property. However, B has a carryover basis adjustment to ordinary income property of $25 under §§ 1.743-1(g)(2)(ii) and 1.755-1(c)(4), which B must treat as applied to section 751 property with fair market value of $0 pursuant to paragraph (b)(2)(ii) of this section. Accordingly, B's net section 751 unrealized loss immediately after the distribution is $25 under paragraph (b)(2)(iii)(A) of this section. If, immediately after the distribution, A disposed of Unrealized Receivable in exchange for $50 cash, A would recognize $50 of net income from section 751 property. Accordingly, A's net section 751 unrealized gain immediately after the distribution is $50 under paragraph (b)(2)(iii)(B) of this section.

(iv) Because B's net section 751 unrealized loss immediately after the distribution ($25) exceeds B's net section 751 unrealized loss immediately before the distribution ($0), the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section, B has a section 751(b) amount equal to $25, the difference of B's share of pre-distribution net section 751 unrealized gain ($0) and B's share of post-distribution net section 751 unrealized loss ($25). Accordingly, paragraph (b)(3)(i) of this section requires B to account for $25 of ordinary income using a reasonable approach consistent with the purpose of this section.

(v) Assume AB adopts an approach under which, immediately before the section 751(b) distribution, B is deemed to--

(A) Receive a distribution of Unrealized Receivable with a fair market value of $25 and a tax basis of $25 (which consists of B's section 743(b) basis adjustment and is determined solely for purposes of applying a reasonable method consistent with the purposes of section 751(b));

(B) Sell Unrealized Receivable to AB in exchange for $25, so that B recognizes $0 of ordinary income, and AB receives Unrealized Receivable with a basis of $25; and

(C) Contribute the $25 to AB. Provided the partnership applies the approach consistently for all section 751(b) distributions, AB's adopted approach is reasonable. After taking into account the tax consequences of the section 751(b) distribution, AB's modified balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
			A	0	25
Real Property	50	100	B	50	75
Totals	50	100		50	100

(vi) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Accordingly, A recognizes no gain on the distribution of Unrealized Receivable, which A takes with a basis of $25.

Example (5). Capital Gain Recognition Required. (i) A, B, and C are each 1/3 partners in a partnership, ABC, that holds Unrealized Receivable 1 with a fair market value of $90, Unrealized Receivable 2 with a fair market value of $30, and nondepreciable real property with a fair market value of $180. The partnership has a section 754 election in effect. Each of the partners has an adjusted basis in its partnership interest of $0 with a fair market value of $100. None of the partners has a capital loss carryforward. ABC distributes to A Unrealized Receivable 1 in a current distribution. To determine if the distribution is a distribution to which section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii) (A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets and its partners' capital accounts are increased under §1.704-1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$0	$90	A	$0	$100
Unrealized Receivable 2	0	30	B	0	100
Real Property	0	180	C	0	100
Totals	0	300		0	300

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately before the distribution, A, B, and C would each be allocated $40 of net income from ABC's section 751 property ($30 each from Unrealized Receivable 1 and $10 each from Unrealized Receivable 2). Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $40 each under paragraph (b)(2)(ii) of this section.

(iii) (A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	$0	$10
			B	0	100
Real Property	0	180	C	0	100
Totals	0	210		0	210

(B) If ABC disposed of all of its assets in exchange for cash in amounts equal to the fair market values of those assets immediately after the distribution, A, B, and C would each be allocated $10 of net income from ABC's section 751 property ($10 each from Unrealized Receivable 2). If immediately after the distribution, A disposed of Unrealized Receivable 1 in exchange for $90 cash, A would recognize $90 of net income from section 751 property. Accordingly, B and C's net section 751 unrealized gain immediately after the distribution is $10 each under paragraph (b)(2)(iii)(A) of this section, and A's is $100 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(iv) Because B and C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section, each of B and C has a section 751(b) amount equal to $30, the amount by which each partner's share of pre-distribution net section 751 unrealized gain ($40) exceeds its share of post-distribution net section 751 unrealized gain ($10). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize $30 of ordinary income using a reasonable approach consistent with the purpose of this section. ABC considers three approaches, the first of which is described in paragraphs (v) and (vi) of this example, the second of which is described in paragraphs (vii) and (viii) of this example, and the third of which is described in paragraph (ix) of this example.

(v) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to recognize $30 of ordinary income. To reflect B and C's recognition of $30 of ordinary income, B and C increase their bases in their ABC partnership interests by $30 each, and the partnership increases its basis in Unrealized Receivable 1 by $60 immediately before the distribution to A. Following the distribution to A, A's basis in Unrealized Receivable 1 is $0 under section 732(a)(2). Because ABC has elected under section 754, the distribution of Unrealized Receivable 1 to A would result in a $60 section 734(b) adjustment to Unrealized Receivable 2. See §1.755-1(c)(1). Because that basis adjustment would have altered the amount of net section 751 unrealized gain or loss computed under paragraph (b)(2) of this section, A must recognize $60 of capital gain prior to the distribution of Unrealized Receivable 1 pursuant to paragraph (b)(3)(ii)(A) of this section. This gain recognition increases A's basis in its ABC partnership interest by $60 immediately before the distribution to A, eliminating the section 734(b) adjustment. See section 732(a)(2). In addition, the partnership increases its basis in Real Property by $60 pursuant to paragraph (b)(3)(iii) of this section, and treats A's gain recognized as reducing A's $60 reverse section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described in this example, ABC's modified balance sheet immediately prior to the distribution is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$60	$90	A	$60	$100
Unrealized Receivable 2	0	30	B	30	100
Real Property	60	180	C	30	100
Totals	120	300		120	300

(vi) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Thus, Unrealized Receivable 1 would take a $60 basis in A's hands under section 732(a), and no section 734(b) adjustment would be made to Unrealized Receivable 2. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	$0	$10
			B	30	100
Real Property	60	180	C	30	100
Totals	60	210		60	210

(vii) Assume alternatively that ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to:

(A) Receive a distribution of Unrealized Receivable 1 with a fair market value of $30 and tax basis of $0;

(B) Sell the unrealized receivable to ABC for $30, recognizing $30 of ordinary income; and

(C) Contribute the $30 to ABC. For the same reasons stated in paragraph (v) of this example, A recognizes capital gain of $60. To accomplish this, A, immediately before the section 751(b) distribution, is deemed to:

(1) Receive a distribution of Real Property with a fair market value of $60 and tax basis of $0;

(2) Sell the Real Property to ABC for $60, recognizing $60 of capital gain; and

(3) Contribute the $60 to ABC.

(viii) The partnership treats the $60 of gain recognized by A as reducing A's $60 reverse section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. Before taking into account the tax consequences of the section 751(b) distribution, ABC's balance sheet is the same as the balance sheet shown in paragraph (v) of this example. After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. The tax consequences under the rules of sections 731 through 736 are the same tax consequences described in paragraph (vi) of this example.

(ix) Assume alternatively that A does not recognize capital gain of $60. As a result, upon the distribution of Unrealized Receivable 1 to A, ABC makes a $60 section 734(b) adjustment to Unrealized Receivable 2. The adopted approach is not reasonable because it is contrary to paragraph (b)(3)(ii)(A) of this section.

Example (6). Capital Gain Recognition Required. (i) (A) Assume the same facts as Example 5 of this paragraph (g), except that Unrealized Receivable 1 has a $9 tax basis, and each of the partners has an adjusted basis in its partnership interest of $3. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$9	$90	A	$3	$100
Unrealized Receivable 2	0	30	B	3	100
Real Property	0	180	C	3	100
Totals	9	300		9	300

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately before the distribution, A, B, and C would each be allocated $37 of net income from ABC's section 751 property ($27 each from Unrealized Receivable 1 and $10 each from Unrealized Receivable 2). Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $37 each under paragraph (b)(2)(ii) of this section.

(ii) (A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$6	$30	A	$0	$10
			B	3	100
Real Property	0	180	C	3	100
Totals	6	210		6	210

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately after the distribution, taking into account the $6 section 734(b) adjustment allocated to Unrealized Receivable 2, A, B, and C would each be allocated $8 of net income from ABC's section 751 property ($8 each from Unrealized Receivable 2). If, immediately after the distribution, A disposed of Unrealized Receivable 1 for cash in an amount equal to its fair market value, A would recognize $87 of net income from section 751 property. Accordingly, B and C's net section 751 unrealized gain immediately after the distribution is $8 each under paragraph (b)(2)(iii)(A) of this section, and A's is $95 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(iii) Because B and C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section, each of B and C has a section 751(b) amount equal to $29, the amount by which each partner's share of pre-distribution net section 751 unrealized gain ($37) exceeds its share of post-distribution net section 751 unrealized gain ($8). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize $29 of ordinary income using a reasonable approach consistent with the purpose of this section. ABC considers two approaches, the first of which is described in paragraphs (iv) and (v) of this example, and the second of which is described in paragraphs (vi) and (vii) of this example.

(iv) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to recognize $29 of ordinary income. To reflect B and C's recognition of $29 of ordinary income, B and C increase their bases in their ABC partnership interests by $29 each, and the partnership increases its basis in Unrealized Receivable 1 by $58 to $67 immediately before the distribution to A. Following the distribution to A, A's basis in Unrealized Receivable 1 is $3 under section 732(a)(2). Because ABC has elected under section 754, the distribution of Unrealized Receivable 1 to A would result in a $64 section 734(b) adjustment to Unrealized Receivable 2 (rather than the $6 section 734(b) adjustment computed prior to the application of this section). See §1.755-1(c)(1). Because that additional basis adjustment would have altered the amount of net section 751 unrealized gain or loss computed under paragraph (b)(2) of this section, A must recognize $58 of capital gain prior to the distribution of Unrealized Receivable 1 pursuant to paragraph (b)(3)(ii)(A) of this section. This gain recognition increases A's basis in its ABC partnership interest by $58 to $61 immediately before the distribution to A. In addition, the partnership increases its basis in Real Property by $58 pursuant to paragraph (b)(3)(iii) of this section, and treats A's gain recognized as reducing A's $60 reverse section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described in this example, ABC's modified balance sheet immediately prior to the distribution is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$67	$90	A	$61	$100
Unrealized Receivable 2	0	30	B	32	100
Real Property	58	180	C	32	100
Totals	125	300		125	300

(v) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Thus, A would take a $61 tax basis in Unrealized Receivable 1 under section 732(a), and a $6 section 734(b) adjustment would be made to Unrealized Receivable 2. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$6	$30	A	$0	$10
			B	32	100
Real Property	58	180	C	32	100
Totals	64	210		64	210

(vi) Assume alternatively that ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to:

(A) Receive a distribution of Unrealized Receivable 1 with a fair market value of $29 and tax basis of $0;

(B) Sell the unrealized receivable to ABC for $29, recognizing $29 of ordinary income; and

(C) Contribute the $29 to ABC. For the same reasons stated in paragraph (iv) of this example, A recognizes capital gain of $58. To accomplish this, A, immediately before the section 751(b) distribution, is deemed to:

(1) Receive a distribution of Real Property with a fair market value of $58 and tax basis of $0;

(2) Sell the Real Property to ABC for $58, recognizing $58 of capital gain; and

(3) Contribute the $58 to ABC.

(vii) The partnership treats the $58 of gain recognized by A as reducing A's $60 reverse section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the section 751(b) distribution, ABC's balance sheet is the same as the balance sheet shown in paragraph (iv) of this example. After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. The tax consequences under the rules of sections 731 through 736 are the same tax consequences described in paragraph (v) of this example.

Example (7). Capital Gain Recognition Elective.

(i) (A) Assume the same facts as described in Example 6 of this paragraph (g), including that ABC adopts the deemed gain approach described in paragraph (iv), except that ABC does not have a section 754 election in effect. As in Example 6, each of A, B, and C has net section 751 unrealized gain of $37 immediately before the distribution. After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	0	10
			B	3	100
Real Property	0	180	C	3	100
Totals	0	210		6	210

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately after the distribution, because there is no section 734(b) adjustment allocated to Unrealized Receivable 2, A, B, and C would each be allocated $10 of net income from ABC's section 751 property ($10 each from Unrealized Receivable 2). If, immediately after the distribution, A disposed of Unrealized Receivable 1 for cash in an amount equal to its fair market value, A would recognize $87 of net income from section 751 property. Accordingly, B and C's net section 751 unrealized gain immediately after the distribution is $10 each under paragraph (b)(2)(iii)(A) of this section, and A's is $97 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(ii) Because B and C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section B and C each have a section 751(b) amount equal to $27, the amount by which those partners' shares of pre-distribution net section 751 unrealized gain ($37), exceeds their shares of post-distribution net section 751 unrealized gain ($10). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize $27 of ordinary income using a reasonable approach consistent with the purpose of this section.

(iii) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to recognize $27 of ordinary income. To reflect B and C's recognition of $27 of ordinary income, B and C increase their bases in their ABC partnership interests by $27, and the partnership increases its basis in Unrealized Receivable 1 by $54 to $63 immediately before the distribution to A. The distribution to A results in an adjustment to the basis of the distributed Unrealized Receivable 1 under section 732(a)(2), reducing the basis of Unrealized Receivable 1 in the hands of A to $3. Because ABC has not elected under section 754 and does not have a substantial basis reduction under section 734(d), this $60 decrease to the basis of Unrealized Receivable 1 will not affect the basis of other assets held by ABC. Thus, the distribution does not alter the amount of net section 751 unrealized gain or loss computed under paragraph (b)(2) of this section. Accordingly, A is not obligated under paragraph (b)(3)(ii)(A) of this section to recognize gain or income upon the distribution of Unrealized Receivable 1. However, A may elect to recognize $60 of capital gain under paragraph (b)(3)(ii)(B) of this section to eliminate the section 732 basis adjustment to the distributed Unrealized Receivable 1 which would otherwise cause A's net section 751 unrealized gain to be greater immediately after the distribution than it was immediately before the distribution. This gain recognition increases A's basis in its ABC partnership interest by $60 immediately before the distribution to A. In addition, the partnership increases its basis in Real Property by $60 pursuant to paragraph (b)(3)(iii) of this section, and treats A's gain recognized as reducing A's $60 reverse section 704(c) amount in the Real Property. A receives the distributed Unrealized Receivable 1 with a basis of $63, so that the distribution does not increase A's net section 751 unrealized gain. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	0	10
			B	30	100
Real Property	60	180	C	30	100
Totals	60	210		60	210

Example (8). (i) A, B, and C, each domestic corporations, are 1/3 partners in a domestic partnership ABC. ABC purchased 100% of the stock in two foreign corporations, X and Y. X and Y each have one share of stock outstanding. ABC has a basis of $15 in its X share with a fair market value of $150, and a basis of $3 in its Y share with a fair market value of $30. The earnings and profits of X that are attributable to ABC's X stock under section 1248 are $135; the earnings and profits of Y that are attributable to ABC's Y stock are $27. ABC has a section 754 election in effect. Each of A, B, and C has a partnership interest with an adjusted basis of $6 and a fair market value of $60. On January 1, 2013, ABC distributes the Y share to A in a current distribution. To determine if the distribution is a distribution to which section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii) (A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets. Its partners' capital accounts are increased under §1.704-1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows (with the shares of X and Y each reflected as having both an unrealized receivable component and a capital gain component):

	Tax	Book	Capital	Tax	Book
X stock (total)	$15	$150	A	$6	$60
Unrealized receivable	0	135	B	6	60
Capital gain asset	15	15	C	6	60
Y stock (total)	3	30			
Unrealized receivable	0	27			
Capital gain asset	3	3			
Totals	18	180		18	180

(B) If ABC disposed of all of its assets for cash in an amount equal to the assets' fair market value immediately before the distribution, A, B, and C would each be allocated $54 of net income from ABC's section 751 property ($45 each from X stock and $9 each from Y stock). Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $54 each under paragraph (b)(2)(ii) of this section.

(iii) (A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock (total)	$15	$150	A	$3	$30
Unrealized receivable	0	135	B	6	60
Capital gain asset	15	15	C	6	60
Totals	15	150		15	150

(B) If ABC disposed of its asset for cash in an amount equal to the fair market value of that asset immediately after the distribution, A, B, and C would each be allocated $45 of net income from ABC's section 751 property pursuant to §1.704-3(a)(6). A, however, received Y stock, which continues to be section 751 property in A's hands under section 735(a), with a holding period that includes the partnership's holding period under section 735(b). If A disposed of its Y stock for cash in an amount equal to its fair market value, A would recognize $27 of gain under section 751(b) on the Y stock (a foreign corporation described in section 1248) that is included in A's income under section 1248 as a dividend to the extent of the attributable earnings. Accordingly, B and C's net section 751 unrealized gain immediately after the distribution is $45 each under paragraph (b)(2)(iii)(A) of this section, and A's is $72 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(iv) Because B and C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section, B and C each have a section 751(b) amount equal to $9, the amount by which those partners shares of pre-distribution net section 751 unrealized gain ($54) exceeds their shares of post-distribution net section 751 unrealized gain ($45). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize $9 as a dividend under section 1248 using a reasonable approach consistent with the purpose of this section. ABC considers two approaches, the first of which is described in paragraphs (v) and (vi) of this example, and the second of which is described in paragraph (vii) of this example.

(v) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to recognize $9 of gain includible as a dividend with respect to the distribution of the Y stock, which is treated as a sale or exchange for purposes of section 1248. To reflect B and C's recognition of $9 of dividend income, B and C increase the bases in their ABC partnership interests by $9 each, and the partnership increases its basis in the Y share unrealized receivable component by $18 immediately before the distribution. The portion of the unrealized receivable component of the Y share that is deemed to be sold or exchanged under section 1248 has a new holding period beginning on the day after the section 751(b) distribution (“the new holding period portion”). The earnings and profits of $18 attributable to the new holding period portion of the Y share are 2/3 of the total earnings and profits attributable to the Y share immediately before the distribution (B and C's $18 aggregate gain recognized under section 751(b) divided by $27, the aggregate of all the partners' net section 751 unrealized gain immediately before the distribution). The remaining earnings and profits are allocated to the remainder of the Y share. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described in this example, ABC's modified balance sheet immediately before the distribution is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$15	$150	A	$6	$60
Unrealized receivable	0	135	B	15	60
Capital gain asset	15	15	C	15	60
Y stock	21	30			
New holding period portion	18	18			
Unrealized receivable	0	9			
Capital gain asset	3	3			
Totals	36	180		36	180

(vi) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Accordingly, the basis of the distributed Y stock in A's hands is limited under section 732(a)(2) to A's $6 basis in its partnership interest. Pursuant to section 732(c)(3)(B), the $15 decrease in basis from $21 to $6 must be allocated to the distributed components of the Y stock in proportion to their respective adjusted bases. A must allocate the $15 decrease in basis in the Y stock between the new holding period portion (which has a basis of $18) and the remainder of the Y share (which has a basis of $3). Accordingly, A receives the new holding period portion of the Y share with an adjusted basis of $5.14 ($6 multiplied by ($18 divided by $21)), and the remainder of the Y share with an adjusted basis of $0.86 ($6 multiplied by ($3 divided by $21)). Because the basis of the distributed Y stock in A's hands was reduced from $21 (the basis of the Y stock in the hands of ABC) to $6 (the basis in A's hands), ABC must increase the basis of its remaining asset under section 734(b)(1)(B) by $15. ABC must allocate the $15 under §1.755-1(c)(1)(i) to the capital gain portion of the X stock. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$30	$150	A	$0	$30
Unrealized receivable	0	135	B	15	60
Capital gain asset	30	15	C	15	60
Totals	30	150		30	150

(vii) Assume alternatively that ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to:

(A) Receive a distribution of the portion of the partnership's Y stock with a fair market value of $9 and a tax basis of $0;

(B) Sell the Y stock back to ABC for $9, recognizing $9 of gain includible as a dividend; and

(C) Contribute the $9 to ABC. ABC will be deemed to have purchased for $18 a portion of the Y stock unrealized receivable component, which will have a new holding period. The deemed sale of Y stock by B and C to ABC will be treated as a sale or exchange for purposes of section 1248. Provided that the partnership applies the approach consistently for all section 751(b) distributions, Partnership ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed transaction, ABC's balance sheet is the same as the balance sheet shown in paragraph (v) of this example. After taking into account the tax consequences of the section 751(b) distribution, ABC's balance sheet is the same as the balance sheet shown in paragraph (vi) of this example.

(viii) Assume that in a later unrelated transaction, A sells its Y stock at a time when its fair market value, earnings and profits, and adjusted basis have not changed. The sale of Y stock by A is a sale or exchange subject to section 1248. Pursuant to §1.732- 1(c)(2)(v), in determining the dividend portion of its gain on the Y stock under section 1248, A does not take into account the $15 decrease in basis under section 732. Accordingly, upon the sale of the Y stock, A recognizes $9 of gain, the lesser of $9 ($0 gain on the new holding period portion ($18 fair market value minus $18 basis) plus $9 gain on the remainder ($12 fair market value minus $3 basis)) or $9 (earnings and profits attributable to the remainder of the Y share) as dividend income under section 1248. A recognizes $15 of capital gain in addition to the $9 of dividend income ($30 amount realized minus $15 ($6 aggregate basis in Y share plus $9 section 1248 dividend income)).

(ix) Assume that ABC also sells its X stock in a later unrelated transaction at a time when its fair market value has declined to $120 but earnings and profits have remained the same. ABC has not made an election under §1.755-1(c)(2)(vi). In determining the dividend portion of its gain on the X stock under section 1248, ABC does not take into account the $15 increase in basis under section 734(b). Upon the sale of the stock, ABC recognizes $105, the lesser of $105 ($120-$15) or $135 (earnings and profits attributable to the X stock for the partnership's holding period) as dividend income. In addition to the $105 of gain includible as a dividend, ABC recognizes $15 of capital loss ($120 amount realized minus $135 ($30 aggregate basis in X stock plus $105 section 1248 dividend income)).

Example (9). (i) Assume the same facts as in Example 8 of this paragraph (g), except assume that Partnership ABC makes an election under §1.755-1(c)(2)(vi). As in Example 8, paragraph (b)(3)(i) of this section requires each of B and C to recognize $9 as a dividend under section 1248 using a reasonable approach consistent with the purpose of this section for the reasons described in paragraphs (ii) through (iv) of Example 8. Further assume that ABC adopts the deemed gain approach described in paragraph (v) of Example 8. As in Example 8, B and C are each deemed to recognize $9 of dividend income with respect to the distribution of the Y stock, which is treated as a sale or exchange for purposes of section 1248. To reflect B and C's recognition of $9 of dividend income, B and C increase the bases in their ABC partnership interests by $9 each. The partnership increases its basis in the Y share unrealized receivable component by $18 immediately before the distribution. The portion of the unrealized receivable component of the Y share that is deemed to be sold or exchanged under section 1248 has a new holding period beginning on the day after the section 751(b) distribution ("the new holding period portion").

(ii) Because ABC makes an election under §1.755- 1(c)(2)(vi), the distribution of the Y share to A results in a $15 section 734(b) adjustment to the unrealized receivable component of the X share. Because that basis adjustment would have altered the amount of net section 751 unrealized gain or loss computed under paragraph (b)(2) of this section, A must recognize $15 of gain with respect to the X share pursuant to paragraph (b)(3)(ii)(A) of this section. Also pursuant to paragraph (b)(3)(ii)(A) of this section, A's recognition of income with respect to the X stock is a sale or exchange for purposes of section 1248 and begins a new holding period for this portion of ABC's X stock, including for purposes of attributing earnings and profits. This income recognition increases A's basis in its ABC partnership interest by $15 immediately before the distribution to A. In addition, the partnership increases its basis in the X share by $15, immediately before the distribution to A. The partnership treats the $15 of dividend income recognized by A as reducing A's $15 reverse section 704(c) amount in the X stock. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described above, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$30	$150	A	$21	$60
Unrealized receivable	0	120	B	15	60
Capital gain asset	30	30	C	15	60
Y stock	21	30			
Unrealized receivable	0	9			
Capital gain asset	21	21			
Totals	51	180		51	180

(iii) (A) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Accordingly, the Y stock would take a $21 basis in A's hands under section 732(a), and no section 734(b) adjustment would be made to the X stock. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$30	$150	A	$0	$30
Unrealized receivable	0	120	B	15	60
Capital gain asset	30	30	C	15	60
Totals	30	150		30	150

(B) If the partnership sells the X stock, the gain recognized is $120 ($150—$30), all of which is recharacterized as a dividend under section 1248. Because A's recognition of $15 of dividend income reduced A's reverse section 704(c) amount in the X stock, this gain is allocated $45 to B, $45 to C, and $30 to A

Section: 761
Failure to Sign Operating Agreement Did Not Mean Taxpayer Was Not a Partner

Citation: Cahill v. Commissioner, TC Memo 2013-220, 9/18/13

The taxpayer in the case of Cahill v. Commissioner, TC Memo 2013-220 (http://www.ustaxcourt.gov/InOpHistoric/CahillMemo.Kerrigan.TCM.WPD.pdf), had entered into a memorandum of agreement,, later followed up by a revenue sharing and allocation agreement with FC, a partnership that changed its name to CFC. The name change was meant to allow Mr. Cahill to claim to be the initial "C" in the organization when he met with customers.

The agreements gave Mr. Christie the right to $125,000 of revenue from one agreement executed by the partnership in which he would perform the services for the customer, and also gave him a drawdown facility which would be repaid out of future profits.

The repayment with future profits would not include the $125,000 payment related to the specific contract. As well, while the drawdown provided for interest to be paid, there was no due date for repayment and no specific guarantee of repayment outside the offset of future profits. The agreements also stated that the amounts received by Mr. Cahill under these agreements would be reported on either a Form 1099MISC or a Schedule K-1.

Mr. Cahill was paid $175,000 during 2008 by the partnership under these agreements. The partnership reported these amounts to Mr. Cahill on a Schedule K-1 prepared for him as a partner. An operating agreement had been drawn up in 2009, but during that year the relationship between the parties soured and the operating agreement was never signed.

Mr. Cahill reported none of the $175,000 on his 2008 return arguing the payment represented a loan and that he never was a partner since he had never signed the operating agreement. The IRS disagreed with his view, holding that the other two agreements established that Mr. Cahill was a partner in 2008 for tax purposes.

The Tax Court agreed, noting:

> Even though petitioner did not sign CFC's operating agreement, both he and FC/CFC acted as though he was a partner of FC/CFC. Petitioner stated at trial that he contacted FC because he wanted to pool his resources and to develop business jointly with FC. When FC/CFC received a payment from Eagle pursuant to the Eagle agreement, FC/CFC would pay over the entire amount to petitioner immediately

The Court went on to reject the "loan" theory as well. First, the Court noted that the payment on the $125,000 agreement was specifically excluded from being part of the drawdown arrangement, thus was a guaranteed payment computed without regard to partnership profits.

The Court notes:

> Petitioner's argument that the payments represent the repayment of loans is not supported by the record. Although payments under the first drawdown facility in theory accrued interest, neither the memorandum of agreement nor the revenue sharing agreement provided any definite date of repayment or a manner of repayment other than from future income allocated to petitioner. The revenue sharing agreement was merely set to terminate on November 30, 2010.

Whether an arrangement is a partnership for tax purposes does not depend on having signed an operating agreement, and merely reciting words that "sound like" a loan doesn't convert a stream of payments into a nontaxable set of loan proceeds. In both cases, the Court found that the substance of what was going on here represented the $175,000 of guaranteed payments shown the Form K-1 that Mr. Cahill received.

Section: 6223
Taxpayer May Not Bifurcate Electiion Out of TEFRA Proceeding per Ninth Circuit, Overruling Tax Court

Citation: JT USA, LP v. Commissioner, CA9, 2014 TNT 221-19, Docket No. 12-70037 reversing 131 TC No. 59), 11/14/14

The Ninth Circuit reversed a holding of the Tax Court regarding whether a taxpayer could separately "opt out" of TEFRA proceedings for an indirect interest held in a partnership, while not opting out for a direct interest, in the case of JT USA, LP v. Commissioner, 114 AFTR 2d ¶2014-5430.

The Tax Court had previously held (131 TC No. 59) that a taxpayer could make such separate elections. That issue was important because the IRS had not started separate non-TEFRA proceedings on the interests that the taxpayers claimed to have "opted out" on and the statute had expired on those statutes. So if the taxpayers are correct that they had "opted out" on their indirect interest, they would not face disallowance of a loss of $36.6 million and a tax bill for about $10 million.

The Tax Court originally ruled that IRC §6223(e)(3)(B) did allow for such a bifurcated election. That provision provides:

> (3) Proceedings still going on.
>
> In any case to which this subsection applies, if paragraph (2) does not apply, the partner shall be a party to the proceeding unless such partner elects—...
>
> > (B) to have the partnership items of the partner for the partnership taxable year to which the proceeding relates treated as nonpartnership items.

The IRS position is that the IRC unambiguously required a partner to make the election for all partnership items for the tax year to be treated as non-partnership items. As well, the IRS points out that Treasury Regulation §301.6223(e)-2T(c)(1) requires the election to be made for all partnership items and is consistent with the House Report on this provision.

The majority of the panel agreed with the IRS and overturned the Tax Court decision. The majority opinion held:

> The meaning of this language is clear and unambiguous, and it means -- as the Commissioner argues -- that unless a partner elects to have *all* of his or her partnership items treated as nonpartnership items, the partner cannot elect out of the TEFRA proceeding. *See Exxon Mobil Corp. v. Comm'r*, 484 F.3d 731, 734 (5th Cir. 2007) ("Use of the definitive article 'the' in the statute supports a conclusion that there is one overpayment rate for each overpayment situation."). In the vernacular, § 6223(e)(3)(B) is an all- or-nothing rule, and that ends our primary inquiry.

As well, the Court noted that even if there was an ambiguity, the Court must give deference to the IRS regulation which would resolve any such ambiguity so long as it is a reasonable interpretation.

As the panel notes:

> The taxpayers' attempt to avoid *Chevron* deference by simply offering a different interpretation of the statute and the regulation misses the point of *Chevron* deference. If the agency's reading of a statute is "a permissible construction of the statute," that reading and interpretation stands and is entitled to respect. *Alarcon v. Keller Industries, Inc.*, 27 F.3d 386, 389 (9th Cir. 1994). Such is the case here.

On the latter point, it may be important to note that the Tax Court issued its opinion prior to the Supreme Court's 2011 decision in *Mayo Found. for Medical Educ. & Research v. United States*, 131 S. Ct. 704, 713 (2011) which the panel drew upon in concluding that the regulation would control even if ambiguity was found to exist.

Section: 6226
Fact that TMP Was Under Criminal Investigation Did Not Invalidate FPAA

Citation: McElroy v. Commissioner, TC Memo 2014-163, 8/12/14

A number of complications arose from the taxpayers' investments in partnerships that claimed tax benefits that sounded "too good to be true" in the case of *McElroy v. Commissioner*, TC Memo 2014-163, http://ustaxcourt.gov/InOpHistoric/McElroyMemo.Nega.TCM.WPD.pdf.

The partnerships in question were marked to individuals as a way to obtain tax benefits well in excess of the amounts invested. Specifically Mr. McElroy invested $37,500 in each of three of these partnerships and expected to obtain $50,000 in reduced taxes from each of the investments, though he'd never see his money again.

The partnerships claimed to work this magic by acquiring cemetery sites, hold the sites for over one year, and then contribute the sites to charities.

There were a couple of issues with how this worked in practice. First, the partnerships purchased the properties for $95,639, $169,167, and $252,373 respectively, but then claimed deductions of $1,864,850, $2,936,700, and $5,282,050 for the properties—a growth in value that seemed suspicious.

But let us assume it's possible the promoter was simply that good at finding undervalued cemetery sites—a bigger problem was that the promoter apparently wasn't very patient. In each case the contributions were made to the charity before a year was up. So regardless of the value of the properties, the partnership's deductions would have been capped at the partnership's (rather low) basis in the properties in question.

The IRS began a partnership level examination of the entity under the TEFRA partnership provisions. Later, in January 1999, the IRS Criminal Investigation Division began a criminal investigation into the promoter. In November of 1999 the IRS mailed a request to extend the statute to the promoter, who was also the tax matter partner. The promoter, citing the criminal investigation underway, declined to extend the statute.

The IRS issued an FPAA at that time and mailed it to the promoter, who filed a petition in Tax Court, with the case being continued under a number of motions. In 2005 the promoter was indicted for activities related to the partnership's tax issues and in 2007 he pled guilty to a portion of the indictment.

In June of 2008 the McElroy's petitioned the Tax Court to remove the promoter (who was incarcerated at that time) as TMP and appoint them to take over as TMP for the partnership case. The taxpayers continued to serve in that capacity until they were removed due to their own bankruptcy case.

In 2013 the Tax Court issued decisions on the partnership proceedings denying the deductions. The IRS then issued notices to the taxpayers for 1996, 1997, 1998 and 1999 related to the partnership adjustments.

The taxpayers argued that these adjustments had been issued well after the three year statute of limitations under §6501(a) and the IRS was simply too late. However, generally IRC §6229 extends that statute with regard to partnership items if an FPAA is mailed to a tax matters partner for the partnership on a timely basis.

The taxpayers in this case argued that the promoter, being under criminal investigation at the time, was barred from serving as the TMP and, therefore, no valid FPAA was issued in a timely manner. The Court first held that this issue was one that should have been raised at the partnership level proceeding—and since it wasn't raised there, generally the taxpayers are barred from raising the issue in their personal proceedings.

But the Court found that even if that was not the case and the issue could be raised at this level, the taxpayers would not prevail. The Court notes:

> Under the second scenario, we assume without deciding that petitioners' challenge to the validity of the petitions filed in the partnership-level proceedings, and petitioners' challenge to the conduct of those proceedings, are proper subjects of this proceeding. Contrary to petitioners' assertion, Mr. Johnston's filing of the petitions as to the FPAAs in his stated capacity as the partnerships' TMP suspended the periods of limitations as to the partnership items underlying the FPAAs until at least one year after our decisions in the partnership-level proceedings became final. This is so regardless of the validity of the underlying petitions. See sec. 6229(d) (requiring only that a petition be filed under section 6226 in order to suspend the period of limitations, with no mention to whether the petition must be valid); H.R. Conf. Rept. No. 105-220, at 679-680 (1997), 1997-4 C.B. (Vol. 2) 1457, 2149-2150 (specifically stating that the period of limitations is suspended notwithstanding whether a petition filed under section 6226 is valid or timely); see also *O'Neill v. United States*, 44 F.3d 803 (9th Cir. 1995). Not to mention that even if Mr. Johnston failed to qualify to act as the partnerships' TMP

> (which we need not and do not decide), he was at least a notice partner in that his name, address, and status as a partner were included in each of [*17] the subject Form 1065. See secs. 6223(a), (b), and (c)(1), 6231(a)(8) (providing with respect to partnerships with no more than 100 partners that the term "notice partner" generally includes any partner whose name and address appear on the relevant partnership returns); see also *Barbados #6 Ltd. v. Commissioner*, 85 T.C. 900 (1985) (holding that the term "notice partner" generally includes any partner whose name and address appear on the relevant partnership returns). Mr. Johnston, as a notice partner, could file the petitions to the extent he could not file the petitions as the TMP.11 See *Barbados #6 Ltd. v. Commissioner*, 85 T.C. 900.

Thus the disallowance of the charitable deduction for the years in question and assessment of tax could move forward.

The taxpayers then argued they should at least be able to deduct the $37,500 they paid to acquire the partnership interests each year as a loss under IRC §165. The Tax Court ruled against that view. A plan to "make charitable contributions" is not a transaction entered into for profit as required by §165(c)(2). The claimed tax benefits do not provide a "profit motive" for entry into the transactions.

Section: 6662
Supreme Court Address Split in Circuits, Finds Sham Partnership Transaction Subject to Gross Valuation Misstatement Penalty

Citation: United States v. Woods, 2013-2 U.S.T.C. ¶50,604, 12/3/13

In the case of *United States v. Woods*, 2013-2 U.S.T.C. ¶50,604, http://www.supremecourt.gov/opinions/13pdf/12-562_k5fl.pdf, the Supreme Court decided a split among the Circuits regarding whether the 40 percent penalty for gross valuation misstatements applied if there was a finding that the transaction in question lacked economic substance.

That is, in the case involved the parties now agreed that that the transaction lacked economic substance and that there was actually no partnership. So the question becomes whether there could be a valuation misstatement (that is, does something have to exist before it can overvalued) as well as whether a valuation misstatement penalty can be adjudicated in a TEFRA partnership proceeding.

A unanimous Supreme Court decided that the valuation penalty not only can, but must apply in this case. Justice Scalia, writing the opinion for the case, first turned to the question of whether a gross valuation misstatement represents a partnership item in a case like this or whether the item must only be handled at the individual partner level.

The opinion notes that it's not simply an issue of whether some details must be handled at the individual level, but rather whether there are partnership wide factors that should be handled at that level to achieve consistency in result. The opinion states:

> We hold that TEFRA gives courts in partnership-level proceedings jurisdiction to determine the applicability of any penalty that could result from an adjustment to a partnership item, even if imposing the penalty would also require determining affected or non-partnership items such as outside basis. The partnership level applicability determination, we stress, is provisional: the court may decide only whether adjustments properly made at the partnership level have the potential to trigger the penalty. Each partner remains free to raise, in subsequent, partner-level proceedings, any reasons why the penalty may not be imposed on him specifically.

More specifically, in this case Justice Scalia notes:

> To be sure, the District Court could not make a formal adjustment of any partner's outside basis in this partnership level proceeding. See *Petaluma*, 591 F. 3d, at 655. But it nonetheless could determine whether the adjustments it did make, including the economic-substance determination, had the potential to trigger a penalty; and in doing so, it was not required to shut its eyes to the legal impossibility of any partner's possessing an outside basis greater than zero in a partnership that, for tax purposes, did not exist.

Reg. §1.6662–5(g) provides that if the adjusted basis of an asset is determined to zero, the asset is by definition grossly overvalued for purposes of the penalty.

The Court also rejected the view that the gross valuation penalty could not apply if the partnership were shams, rejecting the view that the penalty applies only to factual and not legal determinations (the latter being what a finding that the partnership was a sham would be). Also, the court rejected the views expressed by the Fifth and Ninth Circuits that any understatement is "attributable" to the sham status of the entity and not its valuation.

The opinion holds:

> We reject the argument's premise: The economic substance determination and the basis misstatement are not "independent" of one another. This is not a case where a valuation misstatement is a mere side effect of a sham transaction. Rather, the overstatement of outside basis was the linchpin of the COBRA tax shelter and the mechanism by which Woods and McCombs sought to reduce their taxable income. As Judge Prado observed, in thistype of tax shelter, "the basis misstatement and the transaction's lack of economic substance are inextricably intertwined," so "attributing the tax underpayment only to the artificiality of the transaction and not to the basis over-valuation is making a false distinction." Bemont, supra, at 354 (concurring opinion). In short, the partners underpaid their taxes because they overstated their outside basis, and they overstated their outside basis because the partnerships were shams. We therefore have no difficulty concluding that any underpayment resulting from the COBRA tax shelter is attributable to the partners' misrepresentation of outside basis (a valuation misstatement).

The Court also dismissed the partnership's reference to text in the Blue Book as controlling proper interpretation. Justice Scalia notes

> Blue Books are prepared by the staff of the Joint Committee on Taxation as commentaries on recently passed tax laws. They are "written after passage of the legislation and therefore d[o] not inform the decisions of the members of Congress who vot[e] in favor of the[law]." *Flood v. United States*, 33 F. 3d 1174, 1178 (CA9 1994). We have held that such "[p]ost-enactment legislative history (a contradiction in terms) is not a legitimate tool of statutory interpretation." *Bruesewitz v. Wyeth LLC*, 562 U. S. ___, ___ (2011) (slip op., at 17–18); accord, *Federal Nat. Mortgage Assn. v. United States*, 379 F. 3d 1303, 1309 (CA Fed. 2004) (dismissing Blue Book as "a post-enactment explanation").

Rather Justice Scalia compares the Blue Book to a law review article which "may be relevant to extent it is persuasive." But he finds the Blue Book not persuasive in this case.

Specifically he distinguishes the facts of the Blue Book's discussion with the facts of this case, noting:

> But the passage at issue here does not persuade. It concerns a situation quite different from the one we confront: two separate, non-overlapping underpayments, only one of which is attributable to a valuation misstatement.

Thus the holding of the Fifth Circuit was overturned by the Courts and, as a matter of law, a basis creating transaction that relies on creating a partnership that is found to be a scam will be subject to the gross valuation misstatement penalty.

Section: 7525
Assertion of Defense to Potential Penalty Causes Waiver of Attorney-Client Privilege on Opinion Letter

Citation: AD Investment Fund 2000 LLC v. Commissioner, 142 TC No. 13, 4/16/14

In the case of AD Investment Fund 2000 LLC v. Commissioner, 142 TC No. 13, http://www.ustaxcourt.gov/InOpHistoric/ADInvestmentDiv.Halpern.TC.WPD.pdf, a taxpayer was attempting to avoid disclosing the content of opinion letters received in support of a position while still attempting to mount an affirmative defense against any potential penalties under IRC §6662.

The case in hand was yet another "Son of BOSS" tax shelter case and, as in many others, the taxpayers had received opinion letters from law firms giving assurance regarding the tax benefits. Given the consistent failure of taxpayers to carry the tax issues in these cases, preparing a defense against the potentially substantial penalties seems prudent.

However that generally introduces a problem. Attorney-client privilege can be "broken" in various ways, one of which to manage to introduce a position where one of the key facts involves the content of that advice. Thus, for instance, if a taxpayer asserts he relied upon the analysis in an attorney's letter to arrive at a reasonable belief his conduct was proper, the IRS would be granted access to that letter since it's contents are required to judge if the taxpayer truly was acting in reliance on that document and whether such reliance was reasonable given the content of the letter.

Given the nature of many opinions, including various caveats and other issues related to potential exposures, the taxpayer may not been keen to have the IRS reading the document with 20/20 hindsight. Thus the taxpayer was looking for another way to defend himself against penalties.

The taxpayer believed he had such a defense. The regulations at Reg. §1.6662-4(g)(1)(i)(B) provide two ways a taxpayer may establish a reasonable belief that a treatment for a tax shelter was more likely than not the proper treatment:

- The taxpayer analyzes the fact, law and authorities in accordance with the regulations under §6662 and reasonably concludes in good faith that there is a greater than 50-percent chance the position will be upheld if challenged by the IRS or
- The taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.

The taxpayer argued that they were only asserting the first defense, and specifically not asserting the second one. Thus, they argued, the opinion letter itself was not relevant to the issue of whether they should obtain penalty relief.

The Tax Court did not agree. It noted:

> Petitioners' averments also put into contention the partnerships' understanding of those legal authorities and their application of the legal authorities (i.e., the law) to the facts. Finally, the

> averments put into contention the basis for the partnerships' belief that, if challenged, their tax positions would more likely than not succeed in the courts. Petitioners have thus placed the partnerships' legal knowledge, understanding, and beliefs into contention, and those are topics upon which the opinions may bear. If petitioners are to rely on the legal knowledge and understanding of someone acting for the partnerships to establish that the partnerships reasonably and in good faith believed that their claimed tax treatment of the items in question was more likely than not the proper treatment, it is only fair that respondent be allowed to inquire into the bases of that person's knowledge, understanding, and beliefs including the opinions (if considered).

The Court goes on to note that the taxpayers had the opinion letters in hand well before the returns in question were filed. Thus, the Court found:

> The point is that, by placing the partnerships' legal knowledge and understanding into issue in an attempt to establish the partnerships' reasonable legal beliefs in good faith arrived at (a good-faith and state-of-mind defense), petitioners forfeit the partnerships' privilege protecting attorney-client communications relevant to the content and the formation of their legal knowledge, understanding, and beliefs.

Therefore the Court granted the IRS's request to have access to those opinion letters.

Since the tax preparer privilege found in IRC §7525 is based on the attorney-client privilege standards and applies to all preparers (including the vast majority who are not members of the Bar), the same issue would arise for most preparers when deciding how to handle an IRS challenge where the taxpayer had relied upon documents that appear to have §7525 protection.

Similarly, a taxpayer who seeks to "protect" him/herself with an opinion letter needs to understand that the use of that letter to seek penalty relief is going to trigger the need to give the IRS access to the letter--and that may simplify the IRS's ability to attack the underlying transactions.

S CORPORATION DEVELOPMENTS

Section: 41
S Corporation CEO/Shareholder Salary Found Unreasonably High, Court Substantially Reduces Research Credit

Citation: Suder, et al v. Commissioner, TC Memo 2014-201, 10/1/14

In what be looked at as the tax equivalent of the "man bites dog" news story, in the case of *Suder, et al v. Commissioner*, TC Memo 2014-201 we have a case where the IRS argued successfully that a taxpayer who was an owner-employee of an S corporation received excessive compensation. Readers may reasonably wonder if a) the IRS had lost its mind in arguing the same and b) whether a similar level of insanity affected the taxpayer who challenged the position.

But the issue in this case was not a case of payroll taxes, the issue most often driving compensation issues in an S corporation setting. Rather, in this case the issue related to expenses to be counted in determining the amount allowed as a research credit under IRC §41.

The IRS had attempted to attack the research credit in full, arguing the taxpayer's activities failed to qualify for the credit and that there was not sufficient required documentation of such expenses. The Tax Court rejected the IRS position in those areas.

However the Tax Court did find that the CEO's salary needed to be tested for reasonableness under IRC §174(e) in order for the appropriate proportion of it to be treated as expenses includable for research purposes and used in the credit computation.

For the years in question, Mr. Suder's compensation ranged from $8,674,815 to $10,954,175 each year. Those wages constituted approximately two-thirds of the qualified expenses for the years in question.

Under IRC §174(e), amounts are considered research expenses "only to the extent that the amount thereof is reasonable under the circumstances." The Tax Court noted that the House Committee Report related to the enactment of §174(e) stated that the test for reasonableness would be similar to the one under §162 for reasonable compensation.

Since an appeal of the case would be to the Fifth Circuit Court of Appeals, the Tax Court outlined the criteria the Fifth Circuit had held to be relevant in determining reasonableness of compensation. Those tests are:

- The employee's qualifications;
- The nature, extent and scope of the employee's work;
- The size and complexities of the business;
- A comparison of salaries paid with gross income and net income;(5) the prevailing general economic conditions;
- Comparison of salaries with distributions to stockholders;
- The prevailing rates of compensation for comparable positions in comparable concerns;
- The salary policy of the taxpayer as to all employees

The Court noted that the taxpayer, while qualified, had become semi-retired by the years in question, working approximately 20 to 30 hours a week. The Court also noted that the wages of Mr. Suder, a 90% shareholder, and the one other shareholder approximated the ratio of their stock holdings and that Mr. Suder's compensation was far greater than that of any other employee. The Court found no evidence that Mr. Suder's compensation was tied to his contribution to research and development and that, in fact, his involvement there appeared to be less than in previous years.

The Court noted that a key issue was the comparison of Mr. Suder's pay with that of other similarly situated CEOs. The Tax Court effectively rejected the IRS expert's report, but it also rejected a key component of the taxpayer's expert report justifying the CEO's salary—the inclusion of a royalty component that made up the vast majority of the justification in his report for Mr. Suder's income. The Court found that the expert had little justification for the royalty amounts computed and, more to the point, the taxpayer admitted that the company had never paid Mr. Suder based on royalty compensation. The Court concluded that "[i]t appears that Mr. Longnecker included royalty amounts in his compensation analysis in an attempt to justify Mr. Suder's wages" and excluded them as erroneous and unreliable.

Based on that holding, the Court reduced Mr. Suder's compensation to amounts ranging from $2,366,090 to $2,643,907 for the years in question, well below the amounts originally claimed. Given the large portion of the research expenses that relied upon Mr. Suder's compensation, the Court substantially reduced the allowed research credit.

Section: 464
Holding Interest in Ranch in 100% Owned S Corporation, Rather than Individually, Did Not Covert Ranch into Farming Syndicate Required to Use Overall Accrual Method of Accounting

Citation: Burnett Ranches, Limited v. United States, CA5, 2014 TNT 100-17, 5/22/14

The government contended in the case of *Burnett Ranches, Limited v. United States*, http://www.ca5.uscourts.gov/opinions/pub/13/13-10403-CV0.pdf, CA5, 2014 TNT 100-17 that the fact that the operator of the ranch held her interest in an S corporation meant the ranch became a "farming syndicate" for income tax purposes that was required to report on the accrual method of accounting.

Generally, IRC §448 requires "tax shelters" to use the accrual method of accounting. The definition of "tax shelter" is cross-referenced to IRC §461(i)(3) which then includes a reference to "farming syndicates" as defined by IRC §464.

IRC §464(c)(1)(B) provides a general rule that would include any enterprise engaged in farming if more than 35% of the losses are allocated to individuals insulated from liability for debts.

However, the "active management" rule at IRC §464(c)(2) provides an escape hatch from classification as a farming syndicate. It holds that interest held by "individual who has actively participated (for a period of not less than 5 years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation" is not treated as being a "limited entrepreneur" who is protected from liability for debts.

The IRS agreed that Anne Marion, who currently managed the ranch, had actively participated in the management of the operation for more than five years. But the IRS argued that the provision required the interest holder be an "individual" and that Ms. Marion's holding of that interest indirectly via an S corporation meant that the exception did not apply.

The Fifth Circuit did not agree. Interpreted the language found in IRC §464(c)(2)(A) and found that Congress had:

> …expressly provided that any interest in an agricultural venture that is "attributable to" an individual's "active participation" in the "management" of the farming activity for more than five years is not to be treated as the interest of a proscribed limited partner or limited entrepreneur. Importantly, Congress did not restrict sub-subsection (A)'s particular exception to interests of which such an actively participating manager holds legal title in his or her name.

The Fifth Circuit had noted that the taxpayer did not achieve any special tax benefit by holding the property in an S corporation structure. The court found this ranch was not the sort of inactive owner attempting to shelter other income that that provision was meant to reign in.

Rather the Court found that Anne Marion holding her interest via a 100% controlled S corporation as opposed to personally was "a classic example of a difference that does not constitute a distinction."

Section: 1361
QSUB Income Not Allocated on Per Day Basis When Parent Revokes S Election, Despite Parent Not Electing to Close the Books

Citation: CCA 201433014, 8/15/14

If an S election is revoked by a corporation, absent an election to the contrary, the corporation's income is split between the portion of the year it was an S corporation and the portion of the year it was a C corporation by allocating items based on the ratio of C to S days in the full year, pursuant to IRC §1362(e)(2).

Reg. §1.1361-5(a) provides that if a QSUB ceases to be a QSUB, it is treated as if the parent contributed assets to a new corporation immediately before the termination, with stock received in exchange.

The question posed in Chief Counsel Advice 201433014 (http://www.irs.gov/pub/irs-wd/201433014.pdf) is whether the "per day" allocation applies to the QSUB, or whether the "new corporation" rule applies when a QSUB is held by a parent that revokes its S election.

In the case before the IRS, the subsidiary had significant losses following the revocation of the parent's S status. If the "per day" rule applied, the shareholders of the parent would end up benefitting from those losses.

However, the memo concludes that the subsidiary follows a "cut-off" treatment due to the deemed formation of a new corporation. Thus, while income from the parent is allocated on a per-day basis absent an election otherwise, the subsidiary's income through the date of the revocation passes on to the S return, while results following that date become part of the new corporation's return, in this case flowing onto a consolidated C corporation return for the parent.

Section: 1361
Acceptable Liquidation Language for S Corporation LLC Operating Agreement Found in Letter Ruling Granting Inadvertent Termination Relief

Citation: PLR 201351017, 12/20/13

Under the "check the box" rules an LLC can always elect to be taxed as a corporation. In some states this is quite common, since an LLC may offer certain non-tax advantages (such as less onerous annual non-tax reporting) over using a standard state corporate structure.

Using an LLC as the legal form for an S corporation can create issues that sometimes aren't immediately recognized. Often taxpayers don't realize that details in the operating agreements matter and the "boilerplate" default language for LLCs presumes the entity will be taxed as a partnership.

In PLR 201351017 (http://www.irs.gov/pub/irs-wd/1351017.pdf) a buyer of an S corporation, doing its due diligence, uncovered an issue with the operating agreement of the corporation that led to the need to revise the agreement and have the IRS grant inadvertent termination relief.

The problem in this case was that somewhere in the past the entity apparently "misplaced" its initial operating agreement and simply had a new one drafted. The new agreement they adopted was a standard LLC operating agreement that contained language referencing the regulations under IRC §704 and the rules regarding capital accounts.

That language is found in most boilerplate operating agreements because, under the partnership regulations, compliance with the rules under §704's regulations for the maintenance of capital accounts is necessary to be able to demonstrate "economic effect" for any special allocations. Those rules require the maintenance of "book" (a tax term effectively unrelated to any sort of accounting "books" you are used to working with) capital accounts, and those accounts must govern payments in liquidation of the entity.

The problem is that first, the regulations have no application in the corporate setting—it applies only to entities taxed as a partnership. So, at best, it is unnecessary once the LLC has elected to be taxed as a corporation. But in the S setting it can be much worse.

The "one class of stock" rules for S corporations found at IRC §1361(b)(1)(D) render an entity more than one "class of stock" not eligible for S status. Reg. §1.1361-1(l)(2)(i) specifically provides that one of the requirements for an S corporation to have one class of stock is that all "shares" must receive an identical right to distributions in liquidation.

The capital account maintenance provisions in the §704 partnership regulations, incorporated in fully by reference in most boilerplate operating agreements, including the one this entity adopted, do not provide for such identical rights and may not result in distributions that are strictly equal on a per unit (as a "unit" of ownership in an LLC stands in for stock when the S election is made) basis. In fact, in this situation, the entity had determined that there would actually have been a minor difference that would have arisen from the use of that provision.

The entity revised its operating agreement to provide that for so long as entity had in place in election to be taxed as a corporation "all cash and other property remaining for distribution to members pursuant … following satisfaction of all debts and liabilities after an Event of Termination shall be divided among and distributed to the Members pro rata in proportion to their respective membership units of the Company." The operating agreement retained the §704 regulation language, but the above language "overrode" that treatment unless the entity made an entity classification election change back to partnership form.

The IRS granted the requested relief in this case. Of particular interest is the fact that, with this case, advisers can see the details of the type of provision should be in an S corporation operating agreement for an LLC.

Section: 1361
Grant of Profits Interest in LLC Electing S Status Created Inadvertent Termination

Citation: PLR 201337001, 9/13/13

Under the check the box regulations, an LLC may elect to be treated as an S corporation—but that status will only be and remain valid if the LLC otherwise is qualified to have S status and it continues to meet those qualifications. In the case that led to the need to seek relief from the IRS in PLR 201337001 (http://www.irs.gov/pub/irs-wd/1337001.pdf) problems arose with maintaining that qualifications when a plan that would have been perfect for an LLC taxed as partnership was implemented in an LLC that had elected S status.

In this case, the owners of the LLC decided they wanted to give equity interests in the LLC to its employees. However, as is often true, they did not want to give them the identical rights the old owners had, preferring instead to grant them only an interest in future profits of the organization.

To accomplish this, they established a new entity and granted it a profits only interest in the LLC, and then gave the employees ownership of this new entity. The concept is a textbook concept for providing equity based compensation in a partnership arrangement. And, an LLC is a partnership, right?

Well…not right. An LLC an entity for which there is no directly applicable equivalent in the IRC, so the check the box regulations provide for a method to fit this state law entity "square peg" into the IRC's varieties of "round holes." While by default a domestic LLC with multiple owners is treated as a partnership, it has the option to elect to be treated as a corporation. Once that election is made, and until a new election takes place, the entity effectively "becomes" a corporation for federal tax purposes.

Once the LLC elected to be treated as a corporation under the LLC, tax partnership concepts become irrelevant. Unfortunately it appears someone didn't understand that. Had the entity been a C corporation this wouldn't have been a problem—corporations can have multiple classes of equity with different rights. But one of the limitations for corporations that wish to elect S status is that there are restrictions on issuing equity with different rights.

Specifically, an S corporation can only have one class of stock [IRC §1361(b)(1)(D)]. LLC interests are treated "as if" they were stock for this purpose when the entity elects corporate status. Under Reg. §1.1361-1 to be considered a single class of stock, every "unit" of equity must confer identical "per share" rights to proceeds from distributions and in liquidation. The new profits interests violated the liquidation rights requirements, since a profits interest would not receive a proportionate share of pre-existing value.

Once the LLC issued these profits interests, its S status was terminated and it would have reverted to C corporation status. Unfortunately, that was clearly not what the company wanted to happen and, eventually, someone uncovered the problem. So the entity sought relief from the IRS.

In the ruling the IRS granted the relief, but only after the entity unwound the original transaction. In this case, the new owners had not contributed any capital and had received no distributions. A new operating agreement was drafted and adopted, the one that had created the profits interests was revoked. While the ruling does not go into details, presumably either the employees ended up with full equity (which raises a compensation issue for the employees, but also gives the employees increased rights in liquidation) or they were somehow otherwise satisfied. In any event, at the very least we can assume there more than a bit of employee-relations event that took place.

Advisers must remember that once we have "checked the box" to classify an entity, we generally must remember to treat the entity as the elected type and not fall back on dangerous simplifications like "LLCs are partnerships" when dealing with tax planning. Whenever dealing with an LLC in a tax context, the adviser should always take care to verify the entity's "check the box" status and to then proceed with planning for that entity.

Similarly, it's important to remember that S corporations, despite their popularity, are incredibly inflexible vehicles in many ways. If, in fact, the owners have plans in the future that could involve compensation programs such as the one that this entity attempted to implement, the adviser must be sure the client understands when deciding whether to go down the S road that such programs will not be possible in this sort of entity. Whether other alternatives may suffice should be discussed before the election is not, and not discovered, as it was in this case, well after the fact.

Section: 1362
Use of Corporation to Temporary Hold S Shares in a Merger Transaction Meant to Squeeze Out Minority Shareholder Did Not Terminate S Status

Citation: PLR 201444007, 10/31/14

The facts that shares of an S corporation would be temporarily held by a corporation being used to "squeeze out" a minority shareholder in a merge (Type A reorganization) will not result in termination of the S election per the holding of the IRS in PLR 201444007.

In the case in hand there was an apparently troubling minority shareholder of an S corporation that the other shareholders wished to remove as a shareholder. They came up with a plan to do so by taking the following steps:

- A new corporation would be formed and the continuing shareholders would contribute their S shares to this corporation.
- The new corporation would then merge with the corporation in which it now held a controlling interest. The subsidiary (the S corporation) would be the surviving corporation following the merger.
- The minority shareholder would be given cash in exchange for his shares

Thus, at the end of the transactions, the "new corporation" would cease to exist.

In this case the IRS ruled that the transitory holding of a portion (but not all) S shares by the new corporation would not result in a termination of the S status of the corporation. The transaction will be treated as a redemption of the minority shareholder's shares in the S corporation.

Section: 1362
Corporation Denied Permission to Re-Elect S Status Within Five Years of Termination

Citation: PLR 201403001, 1/17/14

The IRS refused to allow a corporation to re-elect S status before 5 years had elapsed following a termination in PLR 201403001 (http://www.irs.gov/pub/irs-wd/1403001.pdf). The ruling indicates some limits on what the IRS will consider to be reasonable cause for a prior loss of S status.

In Revenue Ruling 78-275 the IRS allowed an early re-election of S status for a corporation that lost its S status due to excess passive income. In that corporation's situation the problem arose due to interest income exceeding 20% of gross receipts.

Under a credit agreement with the bank the corporation was required to maintain a time deposit with that bank. When the home construction industry hit a downturn, the corporation was unable to earn enough income to keep the interest income on the time deposit from being greater than 20% of gross receipts. The IRS ruled that the events causing the termination were outside the control of the shareholders and that they were not part of a plan to terminate the election.

In the case involved in this ruling, the taxpayer had made an S election. At some later point, the taxpayer and a regulator agreed that the corporation would make no distributions without the approval of the regulator. When the regulator refused to allow a distribution (presumably to pay the tax on the corporation's income), shares were transferred to an ineligible shareholder, terminating the S election.

The IRS found this case distinguishable from the one outlined in Revenue Ruling 78-275. The IRS found that there had been a business decision made to terminate the election, rather than the election being terminated by events that weren't directly under the control of the corporation.

Section: 1362
IRS Revises Procedures to Obtain Automatic Late S Election Relief

Citation: Revenue Procedure 2013-30, 8/14/13

In Revenue Procedure 2013-30 (http://www.irs.gov/pub/irs-drop/rp-13-30.pdf) the IRS consolidated and simplified the options for automatic permission to file a late S corporation election. The ruling covers the case of a simple late filing of the initial Form 2553 election, a late QSUB or ESBT election, a late QSUB election or the case where the S corporation in addition failed to make an entity election to be treated as a corporation.

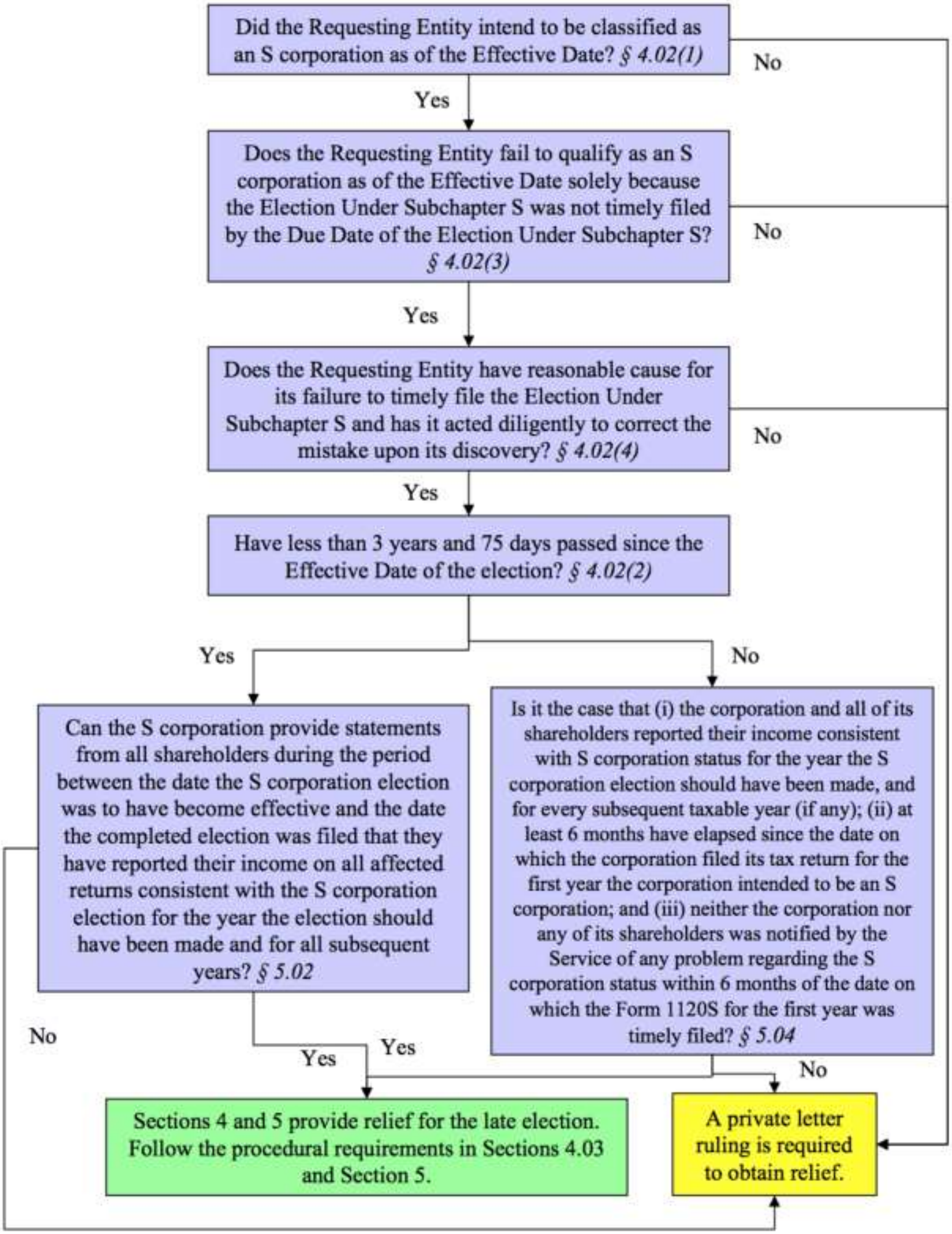
Generally the exclusions apply when the corporation seeks relief within 3 years and 75 days from the effective date of the election—or, more succinctly, within 3 years of the original due date for the missed election. In all cases the corporation must give reasonable cause for the error and provide statements from shareholders indicating that they have properly reported the income as if a valid S election was in place for the intervening years.

The new procedures apply to all requests pending with the National Office as of September 3, 2013 and applications received after that date. If an entity has paid the fee to obtain a private letter ruling that is pending on September 3, and that entity would now qualify for automatic relief, the entity may notify the IRS of an intent to withdraw the ruling request and receive a refund of the user fee.

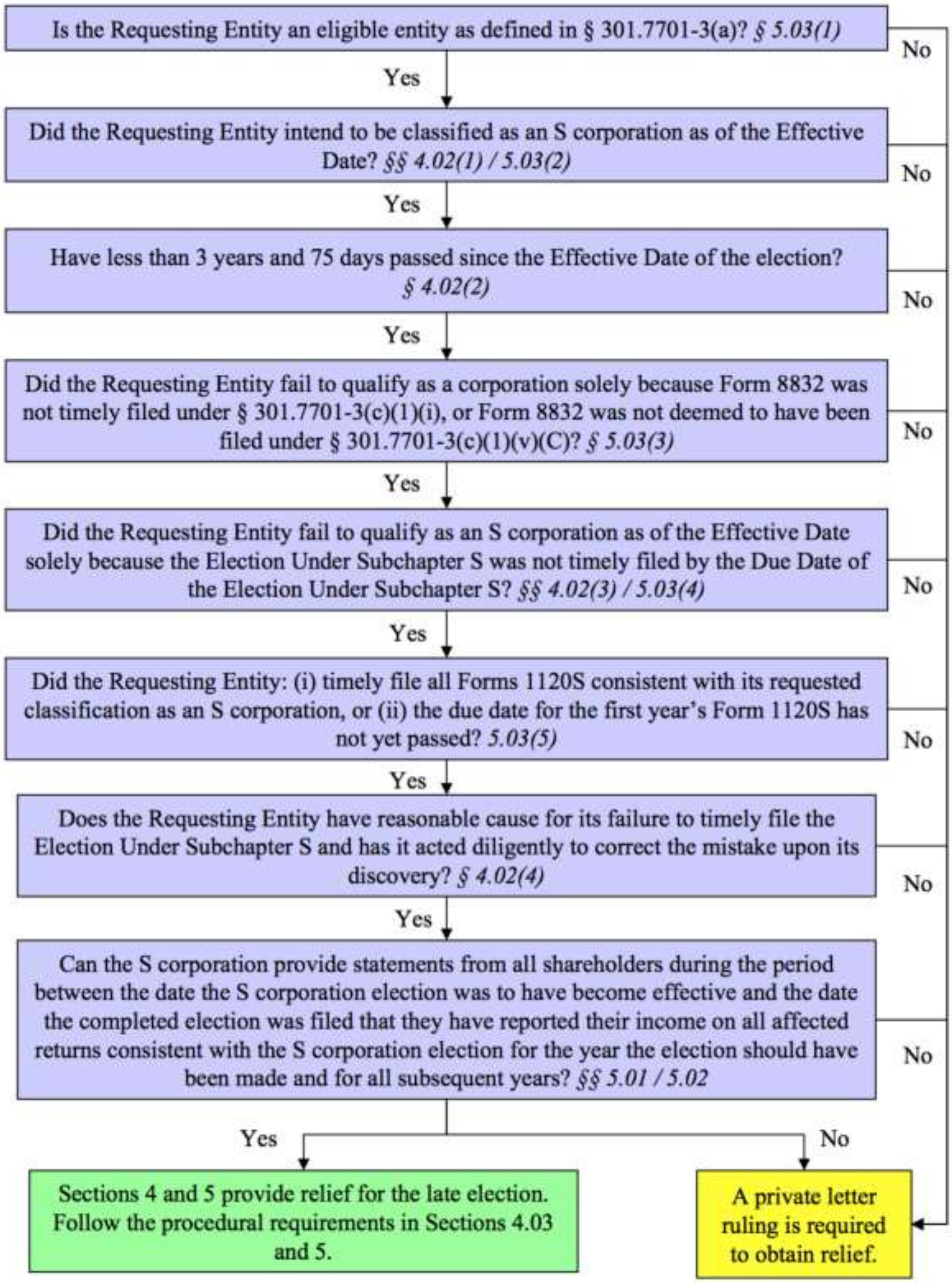
The request to withdraw a pending ruling and receive a refund of the fee must be made by the earlier of the date the private letter ruling is issued or October 18, 2013.

The IRS provides a series of flowcharts to illustrate the application of these rules at the end of the ruling. These flowcharts are reproduced below.

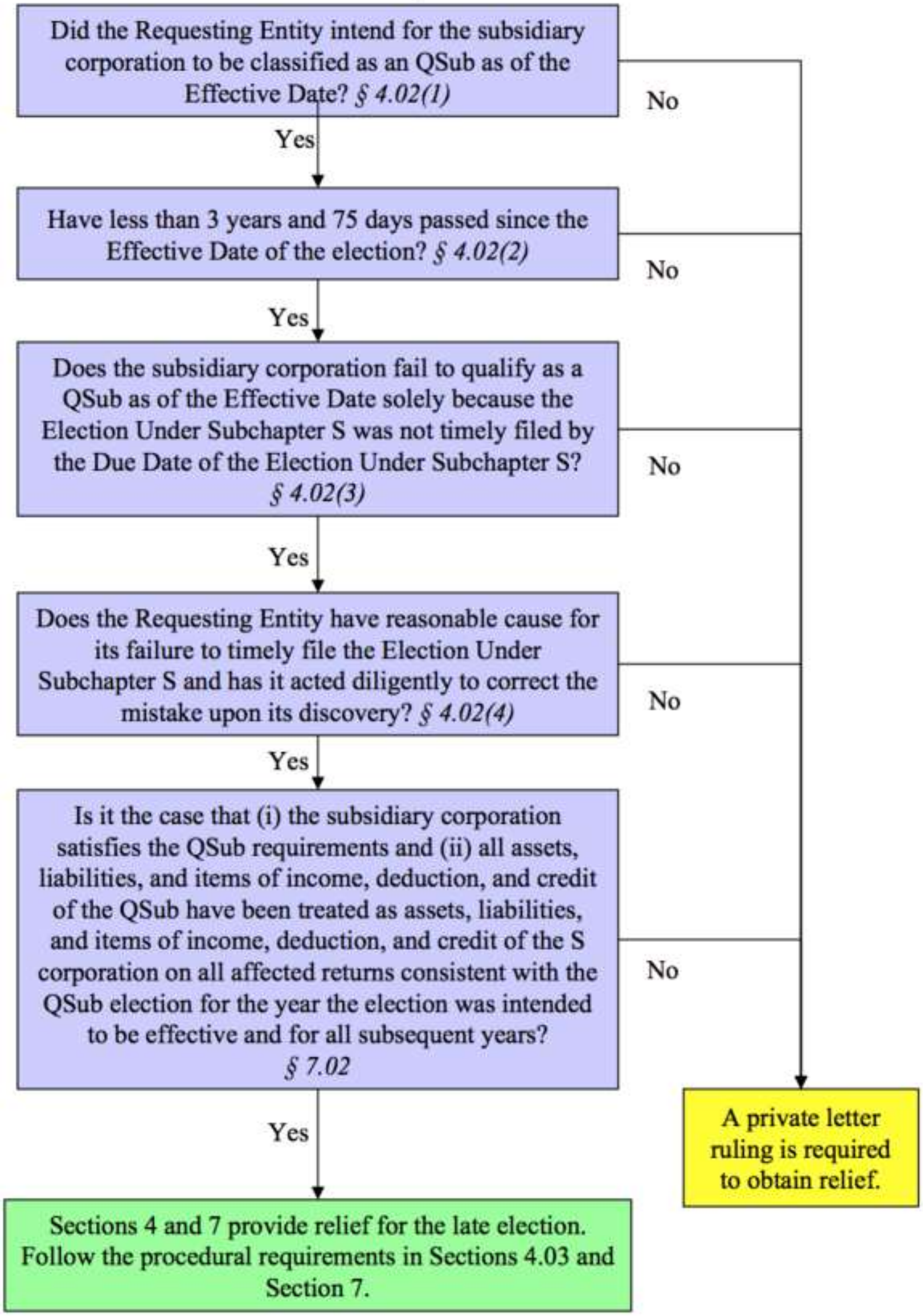
Relief for Late S Corporation Elections



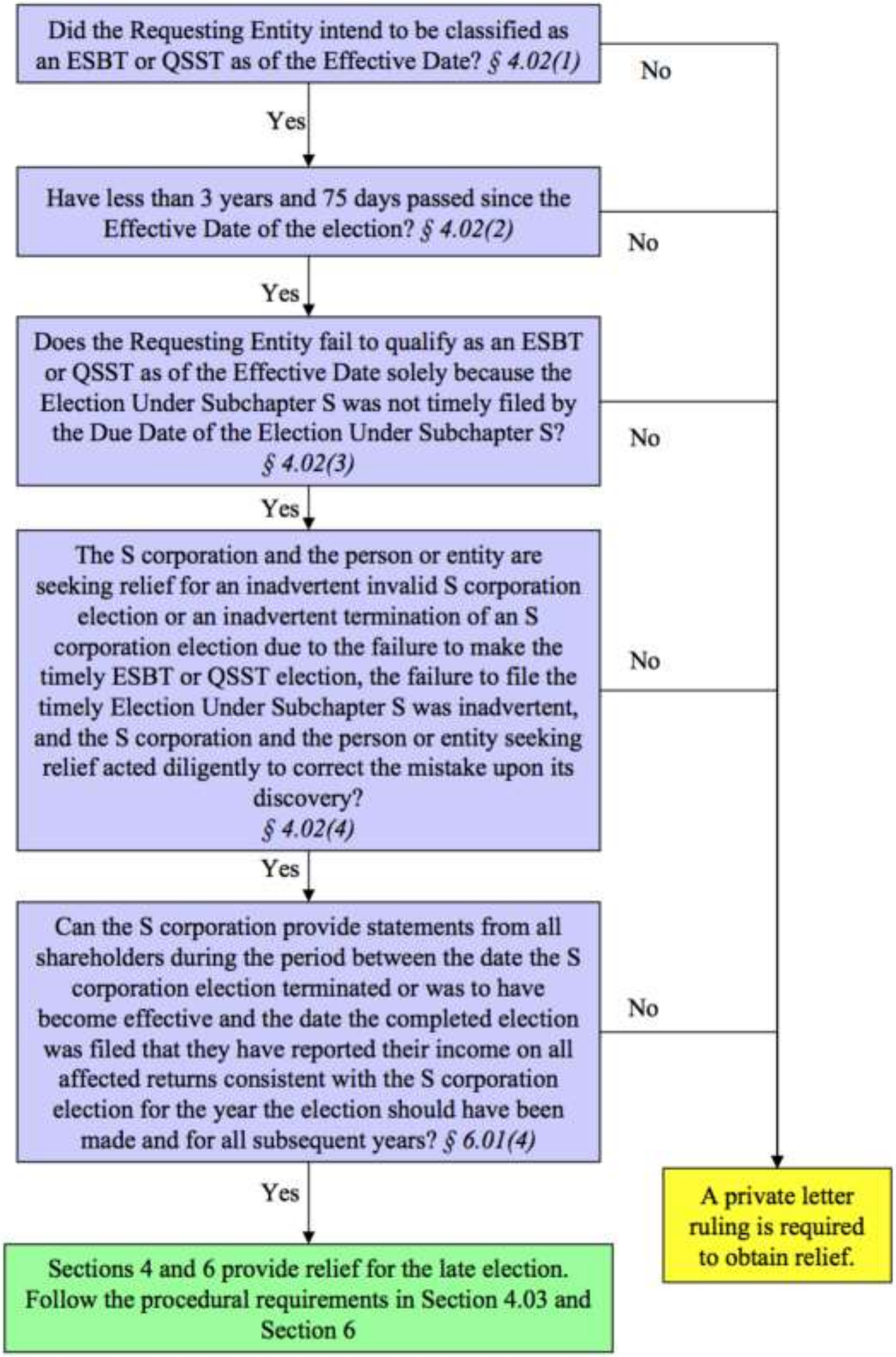
Relief for Late S Corporation and Entity Classification Elections for the Same Entity



Relief for Late QSub Elections



Relief for Late QSST & ESBT Elections



Section: 1366
IRS Finalizes Regulations Regarding "Bona Fide" Debt Rules for S Corporations

Citation: TD 9682, 7/23/14

In TD 9682 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-17336.pdf) the IRS issued final regulations applying a "bona fide" debt standard to debts that are to be allowed to be used in providing basis in S corporations.

The regulations are meant to replace the "actual economic outlay" standard used by courts in S corporation basis cases. Under the new regulations, the S corporation shareholder will get basis if the debt is "bona fide" debt, as determined under general Federal tax principles and depends on all facts and circumstances. [Reg. §1.1366-2(a)(2)(i)]

The regulation also continues to require that a shareholder will only get to increase basis for guaranteeing an S corporation when and if the shareholder actually makes a payment on the debt. [Reg. §1.1366-2(a)(ii)]

The IRS includes four examples with the regulations, but each example simply comes to the conclusion that if the debt in the various circumstances (original shareholder loan, back to back loan, loan distributed to shareholder from another entity and payment on a guarantee) is a bona fide debt under general Federal tax principles, then the shareholder will be given credit for additional basis.

The "general Federal tax principles" are those that have been established in cases decided under other provisions of the IRC (such as debt vs. equity cases in corporate settings, the reality of debt when a bad debt is claimed, etc.). Similarly, the rule would make less relevant prior S corporation cases looking at whether debt "counts" for basis purposes.

The rules apply on and after July 23, 2014. Taxpayer may elect to apply these rules to earlier periods.

Section: 1366
No Economic Outlay for Back to Back Loans With Related S Corporations

Citation: Broz v. Commissioner, 137 TC No. 5, 9/1/11, affd CA6, 2013-2 U.S.T.C. ¶50,488, 8/23/13

The Tax Court in this case (Broz v. Commissioner, 137 TC No. 5, (http://www.ustaxcourt.gov/InOpHistoric/Bro2z.TC.WPD.pdf) noted this case presented several issues, "many of which present questions of first impression as they relate to the ever-evolving cellular phone industry." Even outside that industry, though, this case gives guidance in a number of interesting areas.

Robert and Kimberly Broze got involved in the cellular telephone industry, obtaining licenses in the northern portion of the lower peninsula of Michigan. With his first analog license he organized RFB Cellular, Inc. to which he contributed the license and which began operating a cellular network. RFB elected S status. With the advent of digital cellular systems, he decided to bid on digital licenses. RFB's lenders agreed to provide funds for this venture, but wanted Robert to hold the licenses in a separate entity.

Robert formed Alpine, another S corporation, which obtained the licenses and constructed equipment, as well as individual LLCs to hold the licenses and the operating equipment. However all phone operations remained in RFB, and Alpine's only income was from RFB paying it for licenses.

When Alpine needed additional funds, RFB would get an advance from its bank with the bank's understanding that the funds would be advanced directly or indirectly to Alpine. On RFB's books this was recorded as a loan to Alpine, although notes were drawn up and journal entries made to reflect the amounts as being advanced to Robert and then loaned to Alpine. No security was pledged to RFB to secure these loans, payments were not made and RFB's financial statements specifically indicated the corporation did not plan to demand repayment.

Eventually Robert was informed he needed to increase his basis in the Alpine entities, a new Alpine Entity (Alpine Investments LLC, 100% owned by Robert) was formed to serve as a conduit for loans. The agreement with the bank prohibited funds being distributed to an individual, so the single member LLC was used, the advisers hoped, to both comply with that requirement and still have the tax treatment of the funds being deemed to pass through Robert's hands. At this point the loans now routed through Alpine Investments.

Robert did not personally guarantee the loan to the bank, signing the loan always as an officer of the corporation. He did pledge his RFB stock as collateral for the loan.

The Tax Court found that the loans to the Alpine S entity did not create basis. Although the taxpayer argued it was a pair of back to back loans, the Tax Court found there was no evidence of such an event actually happening and, as well, that RFB was not an "incorporated pocketbook" that routinely paid his expenses. Rather, the Court saw the case being similar to failed related entity loan advance problem found in the case of *Ruckriegel v. Commissioner*, T.C. Memo. 2006-78.

The Court went on to point out that the shareholders could not show they had made a true economic outlay in the supposed back to back loan transaction. A mere pledge of personal assets is not sufficient to show such an economic outlay and they held no personal guarantee on the loan either.

The Court continued to look at a question of whether Mr. and Mrs. Broz were at risk for the loans to any of the entities. For at-risk purposes pledges of personal property can be included in the at-risk amount under §465(b)(2)(B), but that is not true if the pledged property is used in the business. The pledged property in this case was the RFB stock.

The Court found that because all income of the Alpine entities came from RFB, that the RFB stock did constitute property used in the business. Additionally, the fact that the taxpayers were not otherwise liable (aside from the potential loss of their RFB stock) and that there was no realistic potential they could actually experience a loss argued for not including the debts in question as amounts at risk for the Alpine activities.

These matters weren't the only issues in this case, which also had disputes regarding the valuation of assets acquired from another cellular operator and an IRS oral settlement offer that was withdrawn, but the above issues are the ones especially at interest for potential applicability in a number of related party passthrough structures.

The taxpayers appealed the case to the Sixth Circuit Court of Appeals. In its decision, the Sixth Circuit agreed with the Tax Court's view on basis (2013-2 U.S.T.C. ¶50,488, http://www.ca6.uscourts.gov/opinions.pdf/13a0248p-06.pdf).

Section: 1367
Disallowed Loss on Distribution of Property with FMV Less Than Basis From S Corporation Reduces Both Shareholder Basis and AAA

Citation: CCA 201421015, 5/23/14

In IRS Chief Counsel Advice 201421015 (http://bit.ly/PLR1421015) the IRS ruled that a loss disallowed on the distribution of an asset with a fair market value less than the corporation's basis to the shareholder is a non-deductible, non-capital expense pursuant to IRC §1367(a)(2)(D) and thus reduces both the shareholder's basis and the S corporation's AAA.

The memorandum notes that, per IRC §1371(a), C corporation provisions apply to S corporations unless are inconsistent with Subchapter S. Thus, the rule of §311(a) that disallows the deduction of a loss at the corporate level from the distribution of an asset with a fair market value less than its basis applies to S corporations.

But the memorandum notes that such a disallowed loss is not explicitly called out as a non-deductible, non-capital expense under IRC §1367(a)(2)(D). Nevertheless, the ruling concludes that treating it that way makes the most sense under general tax policy and practical considerations.

The memorandum gives an example of how a transaction works "properly" if effect is given to the disallowed loss when computing the shareholder's basis:

> Shareholder forms S Corp in Year 1 by contributing Asset A worth $1000. Shareholder has $1000 basis in his stock, and S Corp has $1000 basis in Asset A. In the hands of the S Corp, Asset A loses $100of value, and is now worth $900. In Year 2, S Corp distributes Asset A, still worth $900 to Shareholder. Shareholder's basis is reduced to $100, and he takes Asset A with basis of $900 (its FMV). If Shareholder is required to also reduce his basis for the disallowed §311(a) loss, his new basis in S Corp is 0. Next, Shareholder liquidates S Corp. He received no proceeds since S Corp has no cash or other assets. If Shareholder is not required to reduce his basis by the disallowed §311(a) loss, he has$100 basis in his stock for which he receives a capital loss. Otherwise, he has no basis, and there is no tax effect to the liquidation of S Corp. Asset A's $100 depreciation is lost.
>
> COMPARE: If, rather than distributing the property directly to Shareholder, S Corp sold the property to a third party for $900, S Corp would have a $100 capital loss which would flow through to Shareholder, reducing his basis to $900. Then S Corp could distribute the $900 to Shareholder.

The memorandum also asserts that most treatises that have considered the issue have come to this conclusion as well, citing specifically Samuel P. Starr & Horacio E. Sobol, *731-2nd T.M., S Corporations: Operations*. As well, it finds support in analogous provisions that apply to consolidated returns.

Section: 1368
AAA From Prior S Election Does Not SurvivePost-Termination Transition Period to Be Used If Corporation Later Re-Elects S Status

Citation: CCA 201446021, 11/14/14

A taxpayer was asserting that if an entity was an S corporation, reverted to C status and then later re-elected S status, any accumulated adjustments account (AAA) from the first S corporation period that survived the post-transition termination period (PTTP) from the conversion to C status should be available for use in the second S corporation period.

In Chief Counsel Advice 201446021 the IRS ruled that this was not the case—AAA from the first S period is lost and not available for use in a subsequent S election period.

The ruling notes that some taxpayers attempt to argue that the AAA survives the PTTP by reading IRC §1368(e)(1)(A) and (e)(2) in conjunction with each other. Those sections provide:

> (e) Definitions and special rules
>
> For purposes of this section--
>
> (1) Accumulated adjustments account
>
> (A) In general
>
> Except as otherwise provided in this subparagraph, the term "accumulated adjustments account" means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under this title and the phrase "(but not below zero)" shall be disregarded in section 1367(a)(2) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation. …
>
> (2) S period
>
> The term "S period" means the most recent continuous period during which the corporation has been an S corporation. Such period shall not include any taxable year beginning before January 1, 1983.

Viewing those two provisions in isolation the argument is made that you adjust AAA for years when you are an S corporation and it simply doesn't change (except for changes provided when the entity is in a post-transition termination period) when the corporation has C status. Thus a new S election would inherit the old, unmodified, AAA from the prior S election period.

However, the IRS points out that (e)(2) defines S period as the <u>most recent continuous period</u> during which the entity has been an S corporation. Thus the period of the prior election ceases to be an "S period" for purposes of §1368 once a new election takes effect—so that AAA resets to zero.

The memo notes as well:

> If AAA survives the PTTP, but may not be adjusted during the C corporation period under § 1368(e), certain events, such as redemptions, occurring while the taxpayer is a C corporation may economically require the adjustments forbidden by the statute, leading to distortions.
>
> Additionally, a shareholder's outside basis in his S corporation stock generally will reflect taxable income of the corporation while it is an S corporation, and that outside basis will not disappear when the S corporation status changes. Even though, at first blush, it might appear that a corporation that fails to distribute its AAA during the PTTP will lose the ability to make tax-free distributions of previously taxed income when it reelects S corporation status in a subsequent period, we do not believe this is the case. Rather, the corporation retains the ability to make tax-free distributions from the shareholder's outside basis, it simply must distribute out of its E&P first. Thus, we believe the question becomes one of a timing difference, not a permanent difference in the taxability of corporate distributions.

Thus, the memo concludes, the taxpayer is in error.

The practical effect of this is that the "old" AAA will end up placed "under" all of the corporation's C corporation earnings and profits, and thus not available to insulate distributions from the S corporation from taxation as tax dividends (as defined by §316, which looks to distributions coming out of earnings and profits).

Section: 6501
Shareholder Return Filed Before S Corporation Return Opened Up Six Year Statute of Limitations

Citation: CCA 201333008, 8/16/13

In Chief Counsel Advice 201333008 (http://www.irs.gov/pub/irs-wd/1333008.pdf) the IRS ruled regarding whether it is possible that a late filed S corporation could be deemed to have properly apprised the IRS of a substantial understatement of gross income, such that the six year statute of limitations on assessments under IRC §6501(e) would not apply to the shareholder.

In the case in question the taxpayer had filed a return more than three years earlier reporting an amount of S corporation flow through income. After the normal statute on assessing tax against the shareholder had expired, but prior to the expiration of a six year statute, the S corporation finally got around to filing its return.

The S corporation return disclosed gross income well in excess of 125% of the net income reported on the taxpayer's Form 1040 for the year in question. The question that arose was whether the later filing of the S corporation return was sufficient to apprise the IRS of the gross income being reported by the taxpayer.

The author of the advice concludes the answer is no. Only a return that had been filed on or before the date when the taxpayer's return was filed could possibly be considered as having disclosed the gross income being reported on the taxpayer's return. In this case, where the S corporation return had not been timely filed, only the net income reported on the taxpayer's Form 1040 was considered as reported gross income on the return.

Note the swap between reported net income and the question of an omission of gross income in the IRS analysis. Based on the logic of this ruling, a taxpayer in this position who files a tax return based on "estimated" passthrough income would (assuming any allowable expenses at the entity level) be understating gross income even if the report of net income was absolutely accurate.

For example, let us assume a taxpayer was the 100% shareholder of the S corporation. The corporation has gross income of $1,000,000 and allowable expenses of $900,000. The return is not complete when April 15 rolls around and the taxpayer (whose only other income is $500,000 of salary from the S corporation) decides he/she wants to file "on time" out of fear that extended returns are a "red flag" to the IRS (which is an unfortunate urban legend that many clients refuse to be dissuaded from). The taxpayer therefore files a return reporting $500,000 of salary and $100,000 of S corporation income.

Under Reg. §1.1366-1(c)(2) the taxpayer's proportionate share of the S corporation's gross income is considered for purposes of determining if the six year statute applies under IRC §6501(e).

Under the logic of this ruling the tax return disclosed gross income of $600,000 (the $500,000 salary plus the $100,000 of S corporation net income). The actual gross income was truly $1,500,000 ($500,000 salary plus the $1,000,000 S corporation gross income). Thus, even though adjusted gross income would not be changed, the return still had "omitted" $900,000 of gross income (essentially, the S corporation's expenses).

With §6501(e) having now "opened" the statute, the IRS could now exam any item on the return. Such items would not need to have anything to do with the items reported on the S return, since §6501(e) contains no provision restricting its application only to items that are impacted by the omission of income.

Hopefully the courts will not allow the IRS to prevail in a case like this, since the result seems contrary to the purpose of §6501(e) unless the understatement clearly exists due to the understatement of gross income. But, for now, caution should be advised when clients begin pushing for returns to be filed with “estimated” or “preliminary” numbers from a passthrough entity. The ruling also provides additional ammunition regarding the potential negative consequences of failing to file passthrough returns in a timely fashion.

ESTATE AND TRUST DEVELOPMENTS

Section: 67
IRS Issues Final Regulations on Deductions Subject to 2% Limitation for Fiduciary Returns,Delays Effective Date

Citation: TD 9664, 7/16/14

The long awaited (dreaded?) final regulations applying the results of the 2008 Supreme Court decision of *Knight v. Commissioner*, 552 US 181, http://www.supremecourt.gov/opinions/07pdf/06-1286.pdf, were issued by the IRS. These regulations (TD 9664, https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-10661.pdf) apply the 2% of adjusted income limitation applicable to trusts to various expenses, most specifically dealing with "bundled" trustee and investment fee arrangements. These regulations were to apply to tax years beginning on and after May 9, 2014, [Reg. §1.67-4(d)] though the IRS later delayed the effective date to tax years beginning on or after January 1, 2015.

The *Knight* case (also referred to as the *Rudkin Trust* case) resolved a split in the Circuit Courts of Appeal regarding whether payments of investment fees by a trust are to be considered "paid or incurred in connection" with the administration of the trust and would not have been incurred if the property was not held in a trust. Such expenses, as defined at IRC §67(e), are exempt from the general 2% floor on miscellaneous itemized deductions imposed by IRC §67(a).

As well, such expenses are deductible in computing the trust's adjusted gross income. The "net investment income tax" under IRC §1411 is imposed for a trust on the lesser of the trust's undistributed net investment income or the trust's adjusted gross income in excess of the level at which a trust's taxable income is taxed at the maximum rate. Since a large number of trusts have only investment income, for those trusts the §1411 tax is really a tax on "excess" adjusted gross income. For those trusts, if these expenses are not deductible in computing adjusted gross income, the trust will end up paying and additional 3.8% on the amount of such expenses treated as itemized deductions.

The Supreme Court in *Knight* unanimously decided that expenses normally of a type incurred by an individual are not to be considered to meet these tests, regardless of a trustee's position that state law imposes a fiduciary duty on the trustee to seek expert advice on investments, etc. Thus investment expenses are not deductible in computing the trust's adjusted gross income and must be subjected (along with all other miscellaneous itemized deductions) to the 2% floor on such deductions under IRC §67(a).

Immediately commentators began wondering about to deal with situations, common when using a bank or other corporate trustee, where the trustee charges a single fee that includes both trustee services and investment advice. The trustee's fee is an expense that clearly would not be incurred if the assets were not held in trust, but the Supreme Court made clear the investment fees needed to be treated as miscellaneous itemized deductions.

Following the IRS's victory in the case, the IRS issued preliminary guidance on the matter of bundled fees in Notice 2008-32. The original notice provided a one year special rule where bundled fees would not be treated as subject to the 2% limitation and allowed in computing trust adjusted gross income to give time for the IRS to issue more detailed guidance. Later notices extended this relief until such time as final regulations were published in this area.

In September of 2011 the IRS issued proposed regulations on the applicable of the rules related to expense incurred by a trust or estate for income tax purposes that would or would be treated as miscellaneous itemized deductions subject to the 2% floor and not deductible in computing trust adjusted gross income.

Outline of Final Reg. §1.67-4

Reg. §1.67-4(b) details the general tests for costs commonly or customarily incurred by an individual as well as detailing the treatment of certain specific expenses. Reg. §1.67-4(c) details how a trust is to deal with bundled fees.

Expenses Customarily or Ordinarily Incurred by an Individual

The general rule, found at Reg. §1.67-4(b)(1), provides initially that the analysis of whether a cost is "commonly" or "ordinarily" incurred by an individual, the fiduciary must look at the type of product or service rendered to the trust or estate and not the label applied to the fee.

The regulation provides that generally costs incurred in defense of a claim against the trust or estate (or the grantor or decedent) would be a cost "commonly" and "ordinarily" incurred by an individual. However it notes that this would not be true if the claim related to the trust's existence, validity or administration.

While the regulation does not say so, it should be noted that such expenses would not automatically be deductible or, if deductible, subjected to the 2% limit. For instance, if the trust is involved in the conduct of a trade or business and paid legal fees directly related to a claim related to the business, such legal fees would, if they met the general rules for a deductible business expense, be deductible in computing the trust's adjusted gross income and not treated as a miscellaneous itemized deduction. Remember that not all deductions allowed to an individual are subject to the 2% haircut.

Specific Costs

Regulation §1.67-4(b) goes on to give details regarding five specific costs the IRS believes may be especially an issue in this area.

Ownership Costs – Ownership costs are costs that are incurred simply by being the owner of a piece of property such as condominium fees, insurance premiums, maintenance and law services, automobile registration fees and auto insurance costs. Such expenses are commonly or ordinarily incurred by individual owners of such property. [Reg. §1.67-4(b)(2)]

Tax Preparation Fees – An item of special interest to most readers is the treatment of tax preparation fees incurred by a trust or estate.

The regulation provides that expenses incurred for the following tax returns will be treated as costs *<u>not</u>* subject to the 2% floor:

- Estate tax returns
- Generation skipping transfer tax returns
- Fiduciary income tax returns
- Decedent's final individual income tax returns

The costs of preparing all other returns are specifically subject to the 2% floor. The most prominent type of return not excluded from the 2% limit are gift tax returns, the regulation noting that the cost of preparing such is a cost commonly and customarily incurred by individuals. [Reg. §1.67-4(b)(3)]

Investment Advisory Fees – The regulation deals directly with the *Knight* issues at this point. While the Court held that generally investment fees are customarily and ordinarily incurred by individuals, the Court found that in unique situations (not present in the *Knight* case) there could be investment fees triggered solely by unique facts of the matter.

The regulations deal with this issue by providing that investment advisory costs are generally subject to the 2% floor. However, in the "special case" situations discussed by the Court, the regulation will allow the "excess" portion of the fee to be treated as not subject to the 2% floor.

The regulation limits this treatment to incremental costs of investment advice *beyond* those that would normally be charged to an individual investor. Such advice is defined as *additional* charge added *solely* because:

- The advice is being rendered to a trust or estate *and*
- This is due to either
    - An unusual investment objective (presumably provided by the trust or estate documents) *or*
    - There is a need for a specialized balancing of the interests of the parties (*beyond the usual balancing of the interest of current beneficiaries and remaindermen*) such that a reasonable comparison with individual investors would be improper

Even in those cases, only the amount of the fee in excess of what would normally be charged to an individual will escape the 2% haircut.

As this special rule was added to the final regulation primarily to deal with a rather fuzzy statement made by the Supreme Court regarding a theoretical "special" situation what, while not defined, was held not to be the case in *Knight*, it seems reasonable to expect the IRS will be unlikely to find many cases they will deem to reasonably allow this splitting of investment fees. More likely, the IRS will argue that the trust or estate in front of them is "just like" the *Knight* situation in this regard. [Reg. §1.67-4(b)(4)]

Appraisal fees – Like tax preparation fees, the IRS decided to provide a specific list of "not subject to the 2% limit" appraisal fees, with all other appraisal fees being considered of a type normally and customarily incurred by an individual.

Those fees specifically exempted from the 2% limit are:

- Fees incurred to determine the fair market value of assets at the decedent's date of death or alternate valuation date
- Fees incurred to determine value for purposes of making trust distributions
- Fees incurred to determine values required to prepare the trust or estate's tax return or GST return (such as might need to be done to prepare a split-interest trust return for a charitable remainder unitrust).

All other appraisal fees are deemed to be of a type ordinarily and customarily incurred by an individual, with the regulation specifically providing that appraisals incurred for insurance purposes are of this "not excepted" type. [Reg. §1.67-4(b)(5)]

Other Specifically Excluded Costs – Reg. §1.67-4(b)(6) lists the following additional expenses that will not be treated as subject to the 2% limit:

- Probate court fees and costs
- Fiduciary bond premiums
- Legal publication costs of notices to creditors or heirs
- Cost of certified copies of the decedent's death certificate *and*
- Costs related to fiduciary accounts

Bundled Fees

If the estate or trust pays a single fee or expense that covers both costs subject to the 2% limitation and those not subject to such a limit, the fee must be allocated between the costs subject to the limit and those that are not. [Reg. §1.67-4(c)(1)]

Note that this does reach beyond simply corporate trustee fees. The IRS specifically lists the following types of fees as examples of types that may end up with a "mixed" treatment:

- Fiduciary's fee
- Attorney's fee
- Accountant's fee

The regulation then goes on to explain specific situations.

Hourly vs. Non-Hourly fees

The regulation technically only discusses non-hourly fees at Reg. §1.67-4(c)(2), but by implication it also contains guidance for fees charged on an hourly basis.

Specifically the regulation provides that if a fee is *not* charged on an hourly basis, only the portion of the expense attributable to investment advice is subject to the 2% floor.

Presumably this means that if an hourly fee is charged, a more comprehensive split of the fee is required, and the issue is not limited to searching for investment advice.

Expenses Specifically Excluded From Allocation

Even though a fee may be paid to a party charging a bundled fee, specific items of that fee will not be subject to allocation.

Such fees not subject to allocation include:

- Any payments made to third parties out of the bundled fee that would have been subject to the 2% floor if paid directly by the estate or trust
- Any expenses separately assessed by payee of the bundled fee for services that are commonly or customarily incurred by an individual

So, for instance, it would appear that if a corporate trustee were to outsource the investment advice to a third party, that fee paid to the third party would be treated as subject to the 2% limit entirely even though the trust may have just paid a single fee to the corporate entity.

Reasonable Method

The regulation concludes the discussion of bundled fees by providing that any reasonable method may be used to allocate the fees between those subject to the limit and those not subject to the limit. [Reg. §1.67-4(c)(4)]

While giving that broad authority, the regulation then goes on to provide certain factors that can be considered in making the allocation. The regulation does provide that this is not an exclusive list of factors, though clearly drawing from this list may eliminate having to give a detailed defense of the method used if an examination takes place:

- Percentage of the value of the corpus subject to investment advice
- What a third party adviser would have charged for similar advisory services

- Amount of fiduciary's time devoted to investment advice as opposed to dealing with beneficiaries and distribution decisions or other fiduciary matters

The provision goes on to remind readers who may somehow have missed the provision found at Reg. §1.67-4(c)(3) described above that they cannot allocate those fees for which allocation is prohibited.

Delay in the Effective Date

Originally the regulations would have immediately applied to any trusts that came into existence after the issuance of the regulations—thus newly created trusts that came into being after May 8, 2014 would have needed to comply with these rules on a 2014 short calendar year return.

The IRS received comments on this point. As was pointed out in the preamble to the amendment to the regulations issued in July of 2014:

> The Treasury Department and the IRS received a comment raising concerns about the effective/applicability date of the regulations. As issued, the final regulations apply to taxable years beginning on or after May 9, 2014. Therefore, fiduciaries of existing trusts and calendar-year estates would implement the rules beginning January 1, 2015. However, the rules would apply immediately to any non-grantor trust created after May 8, 2014, the estate of any decedent who dies after May 8, 2014, and any existing fiscal-year estate with a taxable year beginning after May 8, 2014. The commentator stated that the effective/applicability date in the regulations does not give fiduciaries of these trusts and estates sufficient time to implement the changes that are necessary to comply with the regulations. Specifically, the commentator is concerned about allowing fiduciaries sufficient time to design and implement the necessary program changes to determine the portion of a bundled fee that is attributable to costs that are subject to the 2-percent floor versus costs that are not subject to the 2-percent floor. In response to these comments, this document amends §1.67-4(d) of the Final Regulations so that the regulations apply to taxable years beginning on or after January 1, 2015.

Thus all trusts will be given time to implement these regulations.

Section: 469
Tax Court Finds Trusts Can Be Real Estate Professionals and Rejects IRS Views on Limiting Tests for Trust Material Participation in Passive Activities

Citation: Frank Aragona Trust v. Commissioner, 142 T.C. No. 9, 3/27/14

The IRS has held internally that, in its view, a trust absolutely cannot function as a real estate professional under IRC §469(c)(7) (see Chief Counsel Email 201244017, 11/2/12) and, for all practical purposes, a trust will have an extraordinarily difficult time meeting the material participation tests for a trade or business to escape passive treatment for income or loss from the activity.

In an extreme example, the IRS had ruled that a trust with a trustee who was the CEO of an S corporation did not meet the material participation requirements with regard to the S corporation activity (TAM 201317010). While the IRS official position had been that a trust must show participation by the trustee (and no one else), that participation had been in the trustee's capacity as a trustee—and in the S corporation CEO's case his participation was as an employee of the corporation.

Of course internal memos are all fine and good—the ultimate test of a position takes place in Court. For a long time we had very little guidance here (a single District Court case, *Mattie K. Carter Trust v. U.S.*, 256 F.Supp.2d 536). While that guidance was taxpayer favorable, rejecting the IRS "trustee only" test, it was a single District Court case which often is a shaky foundation on which to rest a position.

Now we have a lot more—the U.S. Tax Court weighed in with a published opinion rejecting the IRS views entirely. The case is the *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9, http://www.ustaxcourt.gov/InOpHistoric/FrankAragonaTrustDiv.Morrison.TC.WPD.pdf.

First, the Court explicitly rejected the IRS view that a trust, by the nature of being a trust, could not perform the personal services necessary to meet the real estate professional definition necessary to apply IRC §469(c)(7). The Tax Court noted "If the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered 'work performed by an individual in connection with a trade or business./ Sec. 1.469-9(b)(4), Income Tax Regs. We conclude that a trust is capable of performing personal services and therefore can satisfy the section 469(c)(7) exception."

The Court went on to note:

> Indeed, if Congress had wanted to exclude trusts from the section 469(c)(7) exception, it could have done so explicitly by limiting the exception to "any natural person". In section 469(i), the Internal Revenue Code does exactly that. Section 469(i) grants a $25,000 allowance to "any natural person" who fulfills certain requirements. That Congress did not use the phrase "natural person" but instead used the word "taxpayer" in section 469(c)(7) suggests that Congress did not intend to exclude trusts from the section 469(c)(7) exception, despite what the IRS argues here.

The Court also gives short shrift to the IRS's broader view that material participation must be met by the trustees only and only if acting purely in their capacity as trustees. The Court comments:

> On the basis of these legal principles, the IRS would have us ignore the activities of the trust's non-trustee employees. 14 Additionally, the IRS would have us ignore the activities of the three trustees who are employees of Holiday Enterprises, LLC. It reasons that the activities of these three trustees should be considered the activities of employees and not fiduciaries because (1) the trustees performed their activities as employees of Holiday Enterprises, LLC, and (2) it is impossible to disaggregate the activities they performed as employees of Holiday Enterprises, LLC, and the activities they performed as trustees.

Note that the latter argument is exactly the one described in the TAM earlier with regard to the S corporation CEO.

The Court concludes that it is not proper to ignore the employee-trustees. Governing law requires them to act in the interests of the beneficiaries, and in this case their employer was an entity 100% owned by the trust. Thus the Court effectively found it absurd to ignore their activities when counting material participation.

While a victory for taxpayer, it is important to note the facts recited in the above paragraph—this was a case of a trust with trustees who were employees of an entity wholly owned by the trust. In most cases things won't be quite that simple—and, for now, we are left to wonder about the impact if the trust was a minority shareholder, for instance.

This issue has become much more important since the net investment income tax under §1411 has become applicable, especially given the low adjusted gross income threshold at which trusts become subject to the §1411 tax. Hopefully this result will spur the IRS act on comments given in the preamble to the final §1411 regulations that they planned to address active participation rules for trusts in guidance under §469.

Section: 2001
IRS Raises Question Regarding Adequacy of Gift Tax Return Disclosures on 10 Returns When Examining Estate Tax Return and Tax Court Rules the Matter Can Go to Trial

Citation: Estate of Hicks v. Commissioner, TC Memo 2014-100, 5/27/14

In the case of the Estate of Hicks v. Commissioner, TC Memo 2014-100, (http://www.ustaxcourt.gov/InOpHistoric/EstofSandersMemo.Kroupa.TCM.WPD.pdf) the Tax Court was asked by the estate to prevent the IRS from increasing the value of the prior adjusted taxable gifts reported on the estate tax return.

The estate wanted summary judgment for its position, pointing to the changes made in 2001 by Congress that provided a mechanism to prevent the IRS from waiting until an estate tax return was filed to challenge gift tax values—something the IRS was doing here.

But that provision Congress enacted (IRC §2001(f)) only closed down the statute if the gift tax returns disclosed the gifts in a manner that is adequate to apprise the IRS of the nature of the gift.

In this case the IRS examined 10 years of prior gift tax returns, increasing the gift value in 9 of those cases. The estate did not contest those adjustments (no tax was due as the statute of limitations for assessing tax had closed on all of those returns). However the estate did contest the IRS when it went to apply that increase to the Form 706, raising the amount of prior gifts and, by extension, increasing the tax imposed on assets passing through the estate.

The IRS claimed that the disclosure on the gift tax returns did not comply with regulations, failing to properly apprise the IRS of the ownership of a related entity by the corporation whose shares were gifted. The Tax Court did not rule on the merits of that issue at this time, but rather ruled the matter was an issue of fact that would need to be settled at trial.

Advisers preparing gift tax returns need to be cognizant of the requirements of IRC §2001(f) and the related regulations when preparing a gift tax return. While there is not (yet) a resolution of this case, it is evidence the IRS is now using the "check the gift tax return disclosures" tool in estate tax exams.

The problem is that if the gift tax return is found to have insufficient disclosures, there may be a large malpractice liability claim against the preparer of the gift tax return who, the heirs will argue, failed to properly advise the (now) decedent of the issues related to disclosure and/or insure that such proper disclosure was on the return. The claim will be (quite plausibly) that if the disclosures had been made, the IRS almost certainly still would not have challenged the Form 709 and, therefore, the additional tax now due on the Form 706 would not have been due.

Section: 2010
Short Term Automatic Late Election Relief for Certain Estates That Failed to Elect Portability and IRS Grants PLR Relief in Additional Case

Citation: Revenue Procedure 2014-18, 1/27/14 and PLR 201421002, 5/23/14

In Revenue Procedure 2014-18 (http://www.irs.gov/pub/irs-drop/rp-14-18.pdf) the IRS provides a short-term automatic relief provision for the election of portability if the estate failed to timely file a Form 706 in cases where a return is not otherwise required.

The IRS has consistently held that if a due date for an election is set by statute, the IRS has no authority to grant relief to taxpayers seeking such relief. In this case, the IRS determined that while the due date for a portability election is set by statute for an estate required to file a return, the due date for an estate not otherwise required to file a return is set by Reg. §20.2010-2T(a) and not by statute. Thus, while the IRS concludes it cannot grant relief to an estate that was required to file a return that neglected to elect portability, the agency does have the authority to grant relief if a return is not otherwise required.

Section 3 of the ruling provides it applies only if:

- The taxpayer is the executor of the estate of a decedent who
  - Has a surviving spouse;
  - Died after December 31, 2010 and on or before December 31, 2013
  - Was a citizen or resident of the United States on the date of death
- The estate, based on its gross estate and adjusted taxable gifts, was not required to file an estate tax return under IRC §6018(a)
- The estate did not file a Form 706 within the time frame prescribed to elect portability

For purposes of this provision, the term "executor" has the same meaning as under the portability regulations. Thus the executor will be the appointed executor or, if there is no appointed executor, any person in actual or constructive receipt of any property of the decedent. [Reg. §20.2010-2T(a)(6)]

An estate qualifying for automatic relief may obtain it by complying with the requirements found in Section 4 of the procedure. Section 4 requires:

- A person who is eligible to make the election on behalf of the taxpayer must file a complete and properly prepared Form 706 by December 31, 2014 *and*
- The Form 706 must state at the top of the form that the return is "FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)"

Estates that meet the requirements will receive automatic relief under the revenue procedure, and an estate closing letter will be issued acknowledging the receipt of the Form 706. If it is later determined that, in fact, the estate was required to file a return under IRC §6018(a) the grant of relief is "deemed null and void."

If, due to the granting of the late election, a refund of tax will now be due, the ruling provides that the refund request must still comply with the standard limitation period limitations. This could prove a problem if both spouses died early in 2011.

In this case, the example found at Section 5.02 notes that the surviving spouse's estate may end up filing a protective claim for refund (as opposed to a final claim) if the Form 706 to elect late relief for the first spouse to die is not complete by the time the statute would expire on filing a claim for refund of estate tax on behalf of the surviving spouse.

If a taxpayer fails to qualify for automatic relief, the taxpayer may apply for (and pay for) a private letter ruling under the terms of Reg. §301.9100-3. However, if the reason a taxpayer fails to qualify for automatic relief is because an estate tax return was required, the ruling strongly suggests the IRS will claim the agency is unable to grant relief.

Note that this "get of jail free" card will not apply to the estates of individuals who die in 2014 or later. The discussion the IRS gives at the start of ruling suggests that the *Windsor* decision may have been a prime motivation for the IRS to create this relief, since prior to that decision the IRS had held that same-sex spouses were not eligible to make use of portability when one died. However, relief is not limited to same-sex spouses.

The ruling also leaves open a significant *Windsor* issue. If, in fact, a Form 706 was required for the estate of a same-sex spouse prior to the date the *Windsor* decision was handed down, the ruling does not grant relief for an attempt to now make an “after the fact” election. That would be true despite the fact that the IRS was holding prior to that date that the estates of such decedents were not eligible to make such an election.

It remains to be seen if the IRS will decide to create a more general automatic relief provision for portability or simply force future cases to go for a formal ruling. The author suspects one reason the IRS may have gone for a short term fix is to see if Congress decides to grant a more general late election authority to the IRS that would also cover estates of decedents where a Form 706 is otherwise required under IRC §6018(a), as the IRS’s long-standing position is that such relief can only come if Congress give the IRS explicit authority to grant such relief.

But there is hope for those who fail to meet the requirements of Revenue Procedure 2014-18 but are still seeking relief. The IRS has begun to issue private letter rulings in the area (for example see PLR 201421002, http://www.irs.gov/pub/irs-wd/1421002.pdf) that give some inkling of the IRS position in the area.

Consistent with above Revenue Procedure, the IRS outlines that the date in question (the due date for filing a return on which to make a §2010 portability election) has been set by regulation. Although the date for filing a Form 706 is set by statute, the IRS position is that the statutory date only applies to estates required to file a Form 706. While IRS references that date for filing a Form 706 to make the election, the date was defined by the regulation, thus the IRS can grant relief under the general late election provisions of Reg. §301.9100-3.

Note that one key fact is the estate must not otherwise have been required to file a Form 706. If an estate is required to file the form, the IRS position is virtually certain to be that they have no ability to grant late relief since this now becomes an election with a date set by statute, as the statute does tie the election to filing date of a Form 706.

As well, the PLR noted above and other similar ones give rather sparse facts about what happened. In particular PLR 201421002 provided:

> Decedent’s Form 706 was due on Date 2, but the estate did not file a timely Form 706 to make the portability election. The estate discovered its failure to elect portability after the due date for making the election.

Note that it would certainly appear that the executor/personal representative was aware of the possibility of making such an election before the date that this could be an insurmountable issue absent other circumstances explaining how the election as intended to be made but was not.

Section: 2031
Estate's Claimed Discounts on Fractional Interests of Art Allowed in Full When IRS Only Argues No Discounts Are Allowed

Citation: Estate of Elkins v. Commissioner, CA 5, 114 AFTR 2d ¶2014-5249, 9/15/14

The IRS found, at least in the view of the Fifth Circuit Court of Appeals, that by arguing that no discounts should be allowed for the value of fractional interests in art works, it was effectively conceding that if a discount was allowed the taxpayer’s discount would be the one used since the IRS had presented no contrary evidence to support a different discount. In the case of *Estate of Elkins v. Commissioner*, CA 5, 114 AFTR 2d ¶2014-5249 the Fifth Circuit agreed with the Tax Court that the IRS was in error in arguing no discount applied, but erred when the Tax Court rejected the estate’s experts’ values and used its own 10% discount for valuing the fractional interests.

The case involved an estate of a decedent that held 64 pieces of art. He owned a 50% interest in the art, the other ½ being held evenly by each of his three children individually. The other 61 pieces of art he owned a 73.055% interest in, again with each of his children holding an equal share of the remaining 29.945% interest in the art.

The taxpayer and his children imposed numerous restrictions on the transfer of interests in the pieces of art. At trial a daughter testified that the family had no interest in selling the art pieces and would resist any attempt to sell them. She did agree, hypothetically, that she and her siblings might be willing buyers of such art, but only if experts assured her that she was paying a fair price for the interests. She testified that the experts she would look to would be similar to those testifying on the values at trial.

The estate produced three experts to testify on the value of these fractional interests. The Court notes:

> They concluded that any hypothetical willing buyer would demand significant fractional-ownership discounts in the face of becoming a co-owner with the Elkins descendants, given their financial strength and sophistication, their legal restraints on alienation and partition, and their determination never to sell their interests in the art.

The IRS presented no experts on discounts that would be applicable in these cases. Rather the Tax Court heard two IRS rebuttal witnesses, only one of which it deemed to offer testimony germane to the issues in the case. That expert testified that there was no recognized market for partial interests in art, but did not testify there never had been, nor ever could be, such a sale.

Based on that record, the Tax Court concluded that the IRS was in error in arguing no discounts were allowed merely due to the lack of a recognized market in fractional interests. However, the Court found that a buyer would pay a much higher price than the discounts the estate claimed, allowing only a 10% discount from percentage of the agreed upon full market value of 100% interests in the pieces.

The Fifth Circuit found that the Tax Court, as a matter of law, could not impose a different discount level in this case. The Tax Court did not note that it found errors in the testimonies of the estate's experts and also did not note any valid IRS criticisms of that testimony, having rejected the no discounts position.

The Fifth Circuit found first that the Tax Court should have held for the taxpayer based solely on the failure of the IRS to carry its burden of proof once the estate presented initially sufficient evidence to show a discount, triggering a shift in the burden under IRC §7525. But, the Court noted, even ignoring that and using the "preponderance of the evidence" standard the Tax Court claimed to apply, the Court should have allowed the estate's discount because there simply was no other evidence of value of the fractional interests presented.

The case is good news for taxpayers (at least those whose cases would be heard on appeal by the Fifth Circuit), since it indicates that the IRS may decide to take a position that the taxpayer's discounts are excessive rather than that there is no discount—or at least argue the excessive discount position as an alternative theory to support an assessment.

But, more generally, it also shows the risks of a "go for broke" strategy where the party stakes their entire case on one finding.

Section: 2031
Estate Allowed to Move Forward With Claim to Adjust Value of Madoff Securities Account Balance Reported on Estate Return Before Discovery of Ponzi Scheme

Citation: Estate of Kessel v. Commissioner, TC Memo 2014-97, 5/28/14

The IRS and the Estate of Bernard Kessel were disputing the proper value to be included in the estate for an interest in retirement fund held by the decedent at his death in 2006. At first glance this appears to be a simple case, since the interest in question was held in a securities account and the fair values of the securities shown by the investment firm as held at that date the account had a value of $4.8 million.

But the case of the Estate of Kessel v. Commissioner, TC Memo 2014-97 (http://www.ustaxcourt.gov/InOpHistoric/EstofKesselMemo.Kroupa.TCM.WPD.pdf) is a bit more complicated because the investment firm in question was Bernard L. Madoff Investment Securities, LLC.

The estate had filed an estate tax return in 2007 (a year before Bernard Madoff was arrested) and reported a tax due of $1,881,256. After that date (before the arrest of Mr. Madoff) the heirs withdrew over $2.8 from the account.

Following the revelations about Mr. Madoff's operation it became clear that the account for the plan had not held the securities that had been used to arrive at the $4.8 million value. The estate first filed a claim with Madoff Securities trustee for the remaining $3.2 million value that was supposedly in the account when Mr. Madoff was arrested and, as expected, that claim was denied as the trustee pointed out no such securities had actually been acquired.

The estate then filed an amended estate tax return claiming a value of the plan as zero on the date of death. The estate pointed out that there really was "nothing there" and the listed securities were illusory.

The IRS objected to this filing on two points. First, the IRS took the position that the proper asset to value would be the "Madoff account" and not the underlying assets supposedly making up that account.

The Tax Court agreed that, based on the Court of Appeals for the state of New York's ruling in *Simkin v. Blank*, 968 N.E.2d 459, 464 (N.Y. 2012), the account existed up until the time that Mr. Madoff's Ponzi scheme began to come apart. However, the Court withheld judgment on the question of whether that asset or what was held inside that account was the proper asset to value.

The Court fully rejected the IRS's next view that a reasonable buyer of the interest in the Madoff Securities account at time of Mr. Kessel's death would have paid the full face value of the account because the existence of the Ponzi scheme would not be known or reasonably foreseen at the date of Mr. Kessel's death.

The Court, however, gives a justification that suggests the estate may find a number of difficulties in demonstrating the lower value.

The Court outlined the IRS position, with which it would "for purposes of this motion" disagree with (suggesting it may yet agree with it after the facts are presented at trial):

> Respondent argues that a Ponzi scheme, by its very nature, is not reasonably knowable or foreseeable until it is discovered or it collapses. Respondent notes Mr. Madoff's particular skill and that his Ponzi scheme was not disclosed until it collapsed in December 2008. Respondent then reasons that Mr. Madoff's Ponzi scheme was knowable or foreseeable only at the point when it collapsed--when the amount of money flowing out of Madoff Investments was greater than the amount flowing in.

The Court noted that "[s]ome people had suspected years before Mr. Madoff's arrest that Madoff Investments' record of consistently high returns was simply too good to be true" and continued "[w]hether a hypothetical willing buyer and willing seller would have access to this information and to what degree this information would affect the fair market value of the Madoff account or the assets purportedly held in the Madoff account on the date Decedent died are disputed material facts."

Thus, while the estate has been allowed to move forward, it has also been shown the sort of factual evidence it will need to present in order to carry its case. Certainly the mere fact that the heirs (and other Madoff customers) were able to make withdraws right up until the scheme collapsed may make it difficult to get a significant discount off the $4.8 value that, presumably, could have been withdrawn in cash on the date of Mr. Kessel's death.

Section: 2031
Estate's Original Value, and Not Those IRS and Estate Each Argued for at Trial, Was the Proper Value for Estate Tax Purposes

Citation: Estate of Adell v. Commissioner, TC Memo 2014-155, 8/4/14

In the case of *Estate of Adell v. Commissioner*, TC Memo 2014-155, http://www.ustaxcourt.gov/InOpHistoric/EstateofAdellMemo.Paris.TCM.WPD.pdf, both the estate and the IRS agreed that the value of a closely held corporation reported on the decedent's return of $9.3 million was in error. However, what they disagreed about was whether it was worth $4.6 million (as the estate now claimed) or $26.3 million (as the IRS was now claiming).

In fact, this was a significant narrowing of the amount of disagreement, since the estate took the position on a second amended Form 706 that the company was worthless while the IRS had claimed a value of $92.3 million.

The entity in question (STN.Com) provided satellite uplink services to a religious television station located in Michigan. The station was a §501(c)(3) tax-exempt organization who paid STN.Com to send its signal via satellite to cable television and satellite providers.

Franklin Adell, the decedent, owned STN.Com, but his son (Kevin) had been deeply involved in coming up the idea for providing such services. The television station was one that Mr. Adell had acquired and which initially broadcast infomercials. When a competitor lost its affiliation with a local channel, the Adell's channel was able to acquire all of the original programming originally broadcast on that channel.

Kevin had familiarity with religious programming, so he decided to create a 24-hour station broadcasting urban religious ministries and gospel music, meeting with religious leaders who agreed to help him launch the station. He also went to Los Angeles and, with the religious leaders, met with the president of DirecTV to see about having the satellite company carry the programming, which eventually took place.

To utilize the available broadcast space the station had to be a nonprofit entity, so the organization was formed that way and entered into an agreement with STN.Com. The agreement provided that the religious stations would pay STN.Com the lesser of 95% of its net programming revenue or STN's "actual costs" each month for STN.Com's services.

In fact, STN.Com was always paid 95% of the net revenue of the station, which consisted primarily of fees paid to the station by ministers, clergy and other religious leaders with local programs who wished them broadcast nationally on the station. Both Mr. Franklin Adell and his son were paid a minor amount of compensation by the station and a much more significant amount of compensation from STN.Com. As well, both were provided with luxury automobiles and provided other significant non-cash compensation (including paying a $6 million judgment against Kevin from Mr. Franklin Adell's salary).

Originally when Mr. Adell died the estate's valuation expert came up with a value of $9.3 million for STN.Com's stock. The expert used a discounted cash flow analysis after adjusting officer's compensation to reasonable level. However, since Kevin had no employment agreement with the organization, a charge was made against income for the value of the personal goodwill held by Kevin.

Kevin had negotiated the various deals, and the parties in question deal with Kevin. In fact, many were unaware that there was a corporation involved that they were dealing with indirectly. Since Kevin had no employment or non-compete agreement with the corporation, he effectively could pick up and take the business with him.

Following Mr. Adell's death, disputes arose within the family and Kevin's sisters brought suit against him. In reaction to the dispute, the station terminated its agreement with STN.Com and signed a new deal with a corporation that Kevin formed—and which ended up employing the employees of STN.Com.

Following this change of course, the estate filed an amended return on which it claimed that STN.Com had no value whatsoever. The IRS, examining the estate, proposed the $92.3 million value.

When the parties ended up before the Court their positions had modified somewhat, with the estate now believing the true value was $4.3 million while the IRS was now set for a $26.3 million value.

The estate's value came from its original expert and another expert who worked with the same firm, but who had prepared an independent valuation. The major reason for the difference in value is that the original expert claimed that he become aware of the "cost" limit in the contract with the station, and that based on that the entity could never truly show a profit. Effectively, he argued that Franklin Adell and Kevin Adell had taken salary and compensation well beyond a reasonable level and once salaries were adjusted to a reasonable level there would be no future cash flow to buy. Thus the entity was most properly valued at its liquidation level.

The Tax Court did not accept this modification. The Court noted that since the estate had been the original source of the $9.3 million valuation, it had to show that the prior valuation was erroneous before it would be allowed to argue for a lower valuation.

The Court noted that the Company clearly had been profitable for years before Franklin died, and that it continued to be profitable up until the family litigation came in. The financial statements prepared for the Company referred only to the 95% revenue agreement and the station had never attempted to enforce the cost provision. The Court concluded that a buyer who ended up in the same position as the Adells would expect to receive the same treatment, thus the discounted cash flow method was the proper valuation.

The IRS's expert agreed with the idea that discounted cash flow was the proper approach, but took a different route to deal with Kevin's personal goodwill. The IRS expert determined that a buyer could retain Kevin's goodwill by paying him a fixed percentage of revenue that resulted in a much lower charge.

The Tax Court did not accept this view—it found that Kevin's goodwill was far more valuable than what the IRS expert was giving credit for, and that there was no reason to believe Kevin would accept a salary of $1.3 million when he had stepped into the shoes of his father who had earned between $2 million and $7 million in each of the five years prior to his death.

Thus the Tax Court found the original $9.3 million valuation to be the most credible value, and decided to make use of that number in arriving at a value to be included in the decedent's estate.

Section: 2033
Provision Allowing Grantor To Revoke Trust That Would Have Caused Inclusion of GRAT Remainder Interests in Grantor's Estate Found by IRS to be Scrivener's Error

Citation: PLRs 201442042, 201442043, 201442044, 201442045 and 201442046, 10/17/14

In a series of private letter rulings (PLRs 201442042, 201442043, 201442044, 201442045 and 201442046) the IRS allowed a taxpayer who had estate planning trusts drafted by an attorney who ended up with too much confidence in his superior knowledge over the client's accountant to avoid negative consequences from those trusts.

The taxpayer had established grantor retained annuity trusts (GRATs) with trusts for his children as remainder beneficiaries of the trust. Assuming the grantor survives to the end of the trust term and the trust corpus appreciates at a rate in excess of the GRAT payout rate, the mechanism allows for making discounted gifts to the next generation.

An accountant was engaged to prepare the Forms 709. The accountant noticed what he believed (correctly) was a problem—the donor had the right to revoke and/or modify the children's trusts. The accountant contacted the attorney to express his concerns, but the attorney brushed off the issue, pointing out that the accountant was not an attorney and, as such, did not have a proper understanding of the underlying state law.

The accountant, apparently not completely satisfied with this response, wrote up a memorandum to the file of this exchange but nevertheless prepared the Form 709 showing completed gifts in the transactions.

Several years later the donor retained a financial planner to work on financial and estate planning issues. The financial planner, like the accountant, became alarmed when he saw that the children's trusts were revocable by the donor. However, this time the planner consulted a different attorney who confirmed the planner's fears—the revocable nature of the trusts would mean that the remainder interests would be treated as part of the donor's estate even if the donor survived to the end of the term.

The attorney filed an action with a state court to reform the trust to remove the problematical provisions, arguing they represented scrivener's error.

Now the problem was simple—could the donor obtain a letter ruling from the IRS that they would respect that this was merely scrivener's error or would they determine that, in fact, no gift was made until the year in which the offending powers were removed from the trust.

The IRS granted the relief sought. The IRS concluded that clearly the intent of the taxpayer was to make a gift using the GRATs and to remove the assets from his estate. The inclusion of the power to revoke or revise the trusts was a clear error and the IRS agreed that it was proper to treat the situation as if the offending provisions had not been part of the trusts from the beginning.

Section: 2035
Value of Gift Properly Reduced by Actuarial Valuation of Potential Reimbursement of Estate for Additional Tax Due if §2035(b) Triggered by Death Within 3 Years of Gift

Citation: Steinberg v. Commissioner, 141 TC No. 8, 9/30/13

The Tax Court in Steinberg v. Commissioner, 141 TC No.8, http://www.ustaxcourt.gov/InOpHistoric/SteinbergDiv.Kerrigan.TC.WPD.pdf, reversing the position it had previously taken, held that the value of a gift could be reduced when the recipients of the gift agreed to assume any potential estate tax if the donor died within three years.

Generally if a donor dies within 3 years of the date of a gift, the value of the gift and the resulting gift tax is added back to the donor's estate pursuant to IRC §2035(b). While the estate gets credit for the gift tax paid, the inclusion of the gift tax in the estate results in a transfer tax being imposed on both the gift in question and the gift tax itself. In the absence of such a provision, a tax could dramatically reduce his/her transfer taxes by making deathbed gifts.

In the case of McCord v. Commissioner, 120 TC 258 (2003) the Tax Court had held that the potential gift tax was "too speculative" to be considered in valuing a gift. However, on appeal the Fifth Circuit Court of Appeals reversed that holding. Nevertheless, the position was still one that the Tax Court could find applicable outside of that circuit.

In the case in question, appealable to the Second Circuit, the Tax Court again visited the issue. In this case the donees had agreed to pay the gift tax imposed on the gift, creating a traditional "net gift" which, the IRS agreed, mean that the gross amount of the gift could be reduced by the gift tax paid.

However, the donees also agreed, if the donor died within three years, to assume the additional estate tax that would be due pursuant to IRC §2035(b). On the Form 709 reporting the gift, the gifts were further reduced based on an actuarial computation of the "expected" amount of such tax.

While recognizing the tax might never be paid, the Court nevertheless noted that a willing buyer would have demanded some reduction in a purchase price to compensate for the risk of having to pay the additional estate tax. The Court also found that it was clearly a risk that could be valued. Thus, the Court refused to continue to follow the McCord holding, and instead allowed a reduction in the value of the gift for the possibility that an additional estate tax might be paid by the donees.

Section: 2036
Decedent Had Retained Life Estate in Property "Sold" to Annuity Trust

Citation: Estate of Trombetta v. Commissioner, TC Memo 2013-234, 10/21/13

In the case of Estate of Trombetta v. Commissioner, TC Memo 2013-234, http://www.ustaxcourt.gov/InOpHistoric/TrombettaMemo.COHEN.TCM.WPD.pdf, a number of issues were considered by the court. But here we will look at the issues raised under one of the provisions where the IRS has continuing success—the area of retained life estates under IRC §2036(a).

The taxpayer had transferred assets to an annuity trust. While the trust provided for a set payment amount to be paid to the taxpayer, during her lifetime the transferor ended taking both reduced and excess payments from the annuity trust, generally driven by her feelings regarding how much she needed. The trust kept an accounting regarding whether she was owed unpaid funds (plus interest), or whether she owed funds to the trust.

The question of the applicability of IRC §2036(a) (the "retained life estate") rules was raised by the IRS in an attempt to bring the assets in the annuity trust back into the estate. Generally that will bring an asset back into the decedent's estate if the decedent retained the right to possess or use the property for a term that ended upon the decedent's death unless the property was transferred in a bona fide sale for an adequate and full consideration.

The estate first argued that the "bona fide sale" rule should take the assets in the trust outside the reach of IRC §2036(a). The estate argued, relying on the decision in Estate of Bigelow v. Commissioner, 503 F.3d

955, 969 (9th Cir. 2007), aff'g T.C. Memo. 2005-65, argued that so long as there existed bona fide nontax reasons for the transfer that the "bona fide" sale exception applied.

The Tax Court disagreed. The Court noted that the Bigelow case and others that have relied upon it all involved family limited partnerships and not trusts. In this case, the trust was structured as a grantor trust and no other person received a present interest in the entity. Thus, it is a distinctly different situation from a transfer to a partnership.

As well, her stated "nontax reasons" did bear up when compared with what actually happened. The claim was that she wanted to reduce her property management obligations, but in reality she continued to personally manage the properties in the trust. A more plausible reason related to this being merely part of her estate plan, as it was established at the same time as her will was executed at age 72.

The Court then moved on to see if there was an impermissible retained interest. The Court noted that she continued to be in full control of the assets in the trust and managed them. Under the terms of the trust, she retained 50% voting interest control of the trust, and the trust provided that if the trust had income in excess of the annuity amount it could be distributed to her. Thus, the Court found, she retained the same enjoyment of the properties and their income as she did before the transfer to the annuity trust.

The Court also rejected the view that there was a true formal sale for annuity. While the paperwork was structured in that form, in reality, just a "'conduit' for the payment of the income" from the properties.

Section: 2042
Rights to Dividend on Life Insurance Contract Does Not Represent an Incident of Ownership

Citation: CCA 201328030, 7/12/13

Chief Counsel Advice 201328030 (http://www.irs.gov/pub/irs-wd/1328030.pdf) concluded that the right of a decedent solely to the receipt of dividends on a life insurance contract did not constitute an incident of ownership in the policy under IRC §2042.

The decedent had maintained policies pursuant to a divorce agreement with his former spouse. The taxpayer was to pay all necessary premiums on the policies, but had no right to borrow against or pledge the policies and the policies were solely for the benefit of the former spouse. However, the decedent had retained the right to receive any dividends issued on the policy.

While the taxpayer retained a "right" with regard to the policy, the right was only to what the tax law considers to be a refund of the premium paid. The Tax Court, in Estate of Bowers, 23 TC 911 (1955) had concluded, in a case very similar to the one addressed in this memo, that the mere receipt of the right to dividends did not constitute an incident of ownership that would bring the policy back into the estate.

What "incidents of ownership" do include are any of the following rights:

- To change the beneficiary,
- To surrender or cancel the policy
- To assign the policy or revoke an assignment
- To pledge the policy for a loan,
- To obtain from the insurer a loan against the surrender value of the policy

If <u>any</u> such incidents are held by the decedent at the time of death, IRC §2042(2) will cause the entire proceeds to be includable in the decedent. As well, the amount will also come back in the estate if any of those values were held in the three years prior to the death of decedent under IRC §2035(a)(2), even if none are held at the actual date of death.

Section: 2044
Failure to Fund Trusts at Death of First Spouse Proves Costly to Estate

Citation: Estate of Olsen v. Commissioner, TC Memo 2014-58, 4/2/14

A surviving spouse's failure to propery fund the trusts on the death of the first spouse came back to be very costly to his estate in the case of *Estate of Olsen v. Commissioner*, TC Memo 2014-58, http://www.ustaxcourt.gov/InOpHistoric/olsenmemo.chiechi.TCM.WPD.pdf.

Grace Olsen died in December 1998. Under the terms of her trust, property was to be divided into two marital trusts and one family trust, which in this case was meant to be a "credit shelter" or "bypass" trust. Under the design of the plan, the marital trust would end up with the amount that could pass estate tax free at Grace's death ($600,000 at the time). Those assets would escape taxation on Elwood's death, since they would not be includable in his estate.

Conversely, the family trust assets would be includable in Elwood's estate. There was no dispute regarding this issue--family trust assets would be excluded from the estate while the assets of the two marital trusts would be included in Elwood's estate.

So what was the issue? Well it turns out that Elwood appears to have ignored the attorney's attempts to get him fo formally fund the trusts. Rather he treated everything as one pool of assets.

As well, it turns out that Elwood was rather generous, making large gifts to the college that both he and his wife had attended, and where he worked for many years.

When Mr. Olsen died, his executor discovered the apparent failure to fund the trusts. The attorney who drafted the documents advised the executor that he had written to Mr. Olsen multiple times after Grace's passing to formally fund the trusts, but Mr. Olsen never contacted him and he had no records of the trusts being funded. Neither did any records of such funding exist in Mr. Olsen's records.

The executor concluded that, regardless of what Mr. Olsen did, the trusts had to be respected and therefore attempted to determine the proper allocation of the existing assets to the various trusts. Eventually the executor concluded that since the documents clearly contemplated reducing estate taxes that the gifts would be allocated to the marital trusts, and that the vast majority of the remaining assets would be left in the family trust (that is, the bypass trust not subject to estate taxes).

Not surprisingly, the IRS disagreed. In their view since the trusts had never been funded there was nothing in the family trust and all assets were includable in Mr. Olsen's estate as part of the marital trusts.

The Tax Court decided neither party had this correct. The Court agreed that, despite the failure to fund the trust, that all of the trusts existed and that the executor was correct that the remainings assets had to be allocated among the trusts.

But the Court did not agree that the allocation was to be made solely based on the goal of reducing estate taxes. While the Court noted there was such language, there was also language authorizing charitable distributions from the bypass trust by the trustee (who was Mr. Olsen). Interpreting the document and local law the Court found that about 60% of the assets that the executor treated as in the family trust were actually part of the marital trust.

Unfortunately this sort of problem with surviving spouses and estate planning trusts is not all that unusual. Survivors often find these multiple trusts confusing and fail to understand their true purpose. As well, the survivor quite often resents the limitations found in the trust documents, or the suggestion that they are to spend down "their" money while leaving untouched the "kid's" money until their assets are exhausted.

Making sure that clients properly understand the full implications of any estate plan is an important step for all advisers to assure has taken place. As well, *both* spouses need to clearly understand how this will work, since either one may end up being the surviving spouse.

Section: 2051
Estate Not Allowed Discount for Potential Lawsuit Claims Against Trust Assets Included in Decedent's Estate, Supreme Court Denies Review

Citation: Estate of Foster v. Commissioner, CA9, 113 AFTR 2d 2014-1519, cert denied, 12/8/14

The Supreme Court denied certiorari in the appeal of the Ninth Circuit's affirmation of the Tax Court's decision in the case of *Estate of Foster v. Commissioner*, CA9, 113 AFTR 2d 2014-1519, *cert denied.*

The issue in this case involved potential liabilities involving an ESOP plan that acquired the stock of a business decedent and her former spouse had been involved with. The decedent's husband's estate was named as a defendant in a lawsuit brought by ESOP participants alleging breach of fiduciary duty by the decedent's husband, a suit filed just before the sponsor of the ESOP filed bankruptcy.

The ESOP participants sought reimbursement from the marital trusts and the trustee of the trust froze the decedent's right to withdraw funds from one of the marital trusts due to the trustee's concern about being held liable for any such funds withdrawn should the participants prevail.

When the decedent passed, her estate argued that there should be a discount applied (or, in the alternative, a liability deduction allowed) for the potential liability under litigation and the lack of marketability of the assets due to the freeze.

The Tax Court disallowed all of the arguments, and the Ninth Circuit sustained that finding. The Tax Court noted that a buyer of the trust assets would have not demanded a discount, since no liability would have followed the assets to the buyer.

The Court also found that a marketability discount was not warranted due to the freeze. The Court argued that while they may not have been salable by the decedent, that didn't impact the value of the underlying assets.

As far as a potential deduction for a liability went, the Tax Court found that, under the applicable regulations, such a deduction is only allowed if the estate could establish the amount of the liability with reasonable certainty. In fact, the Ninth Circuit noted there were "sharp discrepancies" in expert valuations of the lawsuit, so that no amount of liability had been established with reasonable certainty.

Section: 2051
Appellate Panel Find Tax Court Engaged in Impermissible "Imaginary" Scenarios in Determining Value of Limited Partnership Interest

Citation: Estate of Giustina v. Commissioner, 2014 TNT 235-16, CA9, Docket No. 12-71747, 12/5/14

In the case of *Estate of Giustina v. Commissioner*, 2014 TNT 235-16, CA9, Docket No. 12-71747, the Ninth Circuit Court of Appeals panel took issue with the Tax Court's methodology in arriving at a valuation of an estate interest in a limited partnership in an earlier decision (TC Memo 2011-141).

The Tax Court had concluded there was a 25% likelihood of the liquidation of the partnership in valuing the interest, thus giving a 25% weight to an asset-based valuation and a 75% weight to the valuation of the partnership as a going concern. The Court concluded that, although a buyer of the estate's interest could not unilaterally force a sale, that buyer could form a two-thirds voting block with other partners and force liquidation, an event the Court decided had a 25% chance of occurring.

The Ninth Circuit panel that heard the appeal concluded that view was not supported by the record in the case. The panel notes:

> In order for liquidation to occur, we must assume that (1) a hypothetical buyer would somehow obtain admission as a limited partner from the general partners, who have repeatedly emphasized the importance that they place upon continued operation of the partnership; (2) the buyer would then turn around and seek dissolution of the partnership or removal of the general partners who just approved his admission to the partnership; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the fact that "no limited partner ever asked or ever discussed the sale of an interest." Alternatively, we must assume that the existing limited partners, or their heirs or assigns, owning two-thirds of the partnership, would seek dissolution.

The panel declared that such "imaginary" scenarios are not grounds for coming up with a valuation, noting:

> As in *Estate of Simplot v. Commissioner*, 249 F.3d 1191, 1195 (9th Cir. 2001), the Tax Court engaged in "imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect" with the existing partners. See also *Olson v. United States*, 292 U.S. 246, 257 (1934) (explaining in a condemnation case that, when a court estimates "market value," "[e]lements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable[,] should be excluded from consideration").

The panel also remanded the case to have the Tax Court document the basis for its reduction in half of the Estate's expert company-specific risk premium. While the Court notes this is a finding of fact to which the appellate panel owes a high level of deference, nevertheless the Tax Court must clearly explain the rationale behind its decision on the facts, something the Ninth Circuit found the Court failed to do.

Section: 2056
Unnecessary QTIP Election Treated As If Never Made

Citation: PLR 201338003, 9/20/13

In the case of PLR 201338003, http://www.irs.gov/pub/1338003.pdf, we are reminded of a "fix" for a case where a preparer of a Form 706 erroneously managed to put a credit shelter trust down as a QTIP trust and made a QTIP election. In this case, new counsel for the surviving spouse and the trust asked the IRS to rule the election was a nullity.

The will had provided a traditional estate plan where the decedent's property would split into two trusts, a Marital Trust (Trust 1) and a Credit Shelter Trust (Trust 2). The credit shelter trust was to receive assets that would pass free and clear of estate tax, with the remainder going into the Marital Trust which would be a QTIP trust with the proper election made.

In reality, the estate assets were insufficient to have triggered an estate tax in any event. However, the Form 706 was prepared with the QTIP election filed on behalf of the Credit Shelter Trust.

As the ruling notes:

> In general, under Rev. Proc. 2001-38, 2001-1 C.B. 1335, the Service will treat a QTIP election as null and void for purposes of §§ 2044(a), 2056(b)(7), 2519(a), and 2652, where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. The revenue procedure provides an example where the decedent's will provides for a "credit shelter trust" to be funded with an amount equal to the applicable exclusion amount under § 2010(c), with the balance of the estate passing to a marital trust intended to qualify under § 2056(b)(7). The estate makes QTIP elections with respect to both the credit shelter trust and the marital trust. The QTIP election for the credit shelter trust was not necessary, because no estate tax would have been imposed whether or not the QTIP election was made for that trust. See Rev. Proc. 2001-38, § 2.

The IRS notes that in this case the election was unnecessary to reduce the estate tax. Thus, the trust would not be treated as a QTIP trust and not treated as part of the surviving spouse's estate at death.

Section: 2511
Merger of Companies Controlled by Father and Three Sons Resulted in Disguised Gift from Father to Sons

Citation: Cavallaro v. Commissioner, TC Memo 2014-189, 9/17/14

Advisers must always be aware that any transaction involving related parties may, upon IRS scrutiny, be viewed as having economic results different from those the taxpayer reported for tax purposes. In the case of *Cavallaro v. Commissioner,* TC Memo 2014-189, the Tax Court decided the IRS's view of the transaction more closely reflected the economic reality of the situation than did the taxpayer's reporting position.

In the taxpayer's view, there had been a merger of two companies, one owned by William Cavallaro and one owned by his three sons. The senior Cavallaro's company, Knight Tool Company, made tools and machine parts. In 1982 Mr. Cavallaro and one of sons developed an automated liquid dispensing machine which they called CAM/ALOT. In 1987 the three sons incorporated Camelot Systems, Inc. which sold the CAM/ALOT machines manufactured by Knight.

As you might expect, the overall operations were intertwined, with the companies sharing the same building, used the same payroll and accounting services and collaborated in future development of the machine.

In 1994 Mr. Cavallaro was counseled with regard to his estate plan. During this planning process, it was concluded that the value of the technology related to the machine really resided in the son's company (Camelot Systems). The attorney counseling the Cavallaros concluded that the intellectual property had been transferred when Camelot Systems was formed in 1987.

Unfortunately, there was no documentation that such a transfer had taken place—rather the attorney based the transfer on the fact that Mr. Cavallaro had handed the minute book to one of his sons when Camelot was formed. His position was that this was a "symbolic transfer" of the technology. However, there was no written document backing up this transfer, so the attorney had the Cavallaros prepare affidavits and a "confirmatory" bill of sale for the 1987 transfer.

About the same time, the taxpayer's accounting firm, noticing the potential estate planning problem, arrived at a somewhat different plan. The accounting firm (apparently not aware or, or not persuaded by, the symbolic "transfer" of the intellectual property with the minute book in 1987) decided that the two firms needed to be merged so that Mr. Cavallaro could then begin to transfer interests to his sons. Thus, the accounting firm advised that there should be a merger. The accounting firm appeared to presume that Mr. Cavallaro would end up with a majority of such shares and, presumably, a gifting program would then begin.

In 1995 they merged the two companies into one, with the sons receiving 81% of the shares in the merged entity, executing a "combination" of the two advisers plans. This split of value was based on the attorney's position that since Camelot Systems was the real owner of the intellectual property related to the machine, that company was far more valuable than Knight.

Given their position that each party received an ownership interest based on the value of the companies each owned an interest in, the senior Mr. Cavallaro did not file a gift tax return for 1995.

The IRS decided to conduct an income tax examination the companies for 1994 and 1995. During that exam, the IRS decided that there could be a gift tax issue and began looking to obtain documents from the accounting firm with regard to work done for the companies. The taxpayers fought the IRS's attempt to obtain information, but in 2002 the First Circuit Court of Appeals held for the IRS.

In 2005 the taxpayers filed a Form 709 for 2005, taking the position that there was no taxable gift made during the year. The IRS, initially not undertaking a valuation of Camelot Systems, issued a notice of deficiency on the gift tax issue. Initially the IRS appeared to believe that Camelot Systems was an empty shell company with no value, though by the trial date the IRS had modified its position. In its trial position, the IRS argued that, based on the relative values of the two companies, 35% of the shares should have gone to the sons for their Camelot Systems shares and 65% of the shares should have gone to Mr. Cavallaro for his interest in Knight. Thus, the 46% reduction in shares from what Mr. Cavallaro should have received to the 19% he did receive represented a taxable transfer to his sons.

The IRS position was that the "symbolic" transfer was not a true transfer at all—and, in fact, the parties never viewed the intellectual property as owned by Camelot Systems until after they visited the attorney in 1994.

The Tax Court agreed with the IRS. The Court noted that Knight was the only party listed in public documents as owning any of the intellectual property related to the machine and had claimed ownership of that technology in prior tax filings related to R&D credits.

The Court found:

> If Camelot had offered itself to the market for acquisition claiming ownership of the CAM/ALOT technology, it is inconceivable that a hypothetical acquirer would do anything other than demand to see documentation of Camelot's ownership interest--documentation that we have found does not exist. An unrelated hypothetical acquirer would never have been be satisfied with Camelot's mere assertions of ownership, or its statements that an oral agreement effecting the transfer occurred at some point after Camelot's incorporation. Instead, upon realizing no such documentation was available, an unrelated party either would have offered to purchase Camelot at a much lower price or (more likely) would have walked away from the deal altogether.

Similarly, the Court found:

> Likewise, if Knight were dealing with an unrelated party which sold machines that had been manufactured at Knight's risk by Knight employees on Knight premises using technology developed by Knight personnel, where Knight had owned the only public registrations of intellectual property and had claimed ownership of the technology in prior tax filings, it defies belief to suggest that Knight would have simply disclaimed the technology and allowed the unrelated party to take it. If an unrelated party had purchased Camelot before the merger and had then sued Knight to confirm its supposed acquisition of the CAM/ALOT technology, without doubt that suit would fail. Camelot did not even own the CAM/ALOT trademark registration.

The fact that Knight and not Camelot owned the properties rendered the valuations provided by the taxpayer's experts to be significantly misstated, as they assumed that Camelot owned the property. With that property moved back to Knight, it was clear that the sons had ended up with a disproportionate share of the merged entity. That "extra" interest transferred was subject to gift tax.

However, the Court did find that the taxpayer, having relied on the advice of professionals who were given all relevant facts, had reasonable cause for their failure to file gift tax returns or pay gift tax. Thus the Court found that no penalties were due.

The case is an illustration of the risks of attempting to take advantage of prior "sloppiness" (in this case, the intertwined operations of the two companies) to attempt to argue for an interpretation of the past that just happens to end up accomplishing a taxpayer favorable goal. While sometimes advisers do need to attempt to interpret ambiguities related to past actions where documentation was not maintained, the adviser should be aware that the Court will generally want to see objective evidence that, in fact, what the adviser is now arguing is the proper interpretation is the one that the parties believed at the time.

Similarly, the adviser, to properly serve his/her client, should take a look at available facts (especially those already in the possession of the IRS or that are part of the public record) and determine if a reasonable person could view those facts and come to a contrary result. Unfortunately, putting up a "symbolic" handing over of a minute book against the public registration of the trademark in the father's name and the father's company claiming ownership in prior tax returns to claim tax benefits seems somewhat inadequate justification—and, certainly, the Tax Court did not find it adequate.

Section: 6901
Co-Administrators Deemed to Know Existence of Decedents Unpaid Income Tax Liability, Held Liable When Distributions Rendered Estate Unable to Pay the Tax

Citation: U.S. v. Robert Shriner, DC MD, 113 AFTR 2d ¶ 2014-616, 03/12/2014

In the case of U.S. v. Robert Shriner, DC MD 03/12/2014, 113 AFTR 2d ¶ 2014-616, (http://scholar.google.com/scholar_case?q=robert+shriner&hl=en&as_sdt=4,146&as_ylo=2014&case=15399878182447291119&scilh=0) an executor of a decedent's estate found himself inheriting the decedent's tax liability.

In the matter at hand Robert and Scott Shriner were appointed co-administrators of the estate of Carol Shriner. Carol had failed to file tax returns for 1997 and 2000-2003. The Shriners engaged a law firm to handle Carol's income tax problems and gave the firm power of attorney via an IRS Form 2848.

In May of 2005 the estate filed the delinquent tax returns and the IRS assessed taxes of $276,908 against the estate. The IRS continued to notify the law firm of the outstanding balance due on Carol's returns through

February 15, 2006. On February 15 the estate reported to the supervising Orphan's Court that it made distributions to Robert and Scott totaling $470,963.

The brothers contended that they were unaware of the outstanding tax liability, having relied upon the law firm to advise them in the matter. The District Court ruled that the brothers were bound by their actions in turning over the matter to the law firm, and when the IRS notified the law firm of the outstanding balance they were deemed to have been made aware of that balance.

As the $470,963 distribution left the estate with insufficient assets with which to pay off the IRS, under 31 USC §3713(b) the representatives became personally liable for that shortfall.

The Court in a footnote distinguished this case from the case the brothers attempted to rely upon, the 1999 case of Little v. Commissioner, 113 TC 474. The brothers noted in that case the executor had relied upon the attorney's advice that the estate had no income tax liability. In this case, the footnote points out, the brothers were aware that there was an income tax liability due. They could not "rely" on the fact the law firm may not have told them the balance due or perhaps even somehow "missed" that fact when discussing the distribution.

The case is instructive regarding the responsibilities that estate representatives have to deal with the tax problems of the decedent. As well, it makes clear that merely "hiring an expert" will not suffice to insulate the individual from liability.

Obviously the brothers may now decide to attempt to obtain compensation from the adviser, assuming they can prove their claim that the law firm had either negligently failed to advise them of the tax liability or even approved the distribution that rendered the estate unable to pay the tax bill. And that brings up another point—in many cases, where the federal courts rule an individual cannot escape a liability based upon reliance on a professional, a local court may very well still find a malpractice liability issue with regard to what the professional did or did not do.

TAX PRACTICE AND PROCEDURE DEVELOPMENTS

Section: OPR
OPR Describes When Employees of Corporation Under Examination Become Subject to OPR Jurisdiction

Citation: Alerts from the Office of Professional Responsibility, Issue 2014-12, 9/9/14

In Issue 2014-12 of *Alerts from the Office of Professional Responsibility*, the OPR gave guidance regarding when corporate officers or employees are deemed to be engaging in practice before the IRS subject to the jurisdiction of the Office of Professional Responsibility during an examination of the corporation.

The article notes that the LB&I Communications Agreement operates in a fashion similar to IRS Form 8821, *Tax Information Authorization*. Under the agreement, a corporate taxpayer can designate one for more employees to:

- Discuss tax matters;
- Provide and receive information; or
- Receive and discuss adjustments (or some combination of these three)

The agreement does not authorize such individuals to advocate, negotiate or dispute issues with the IRS. If the corporation wishes to designate an employee to take those actions the corporation must execute a Form 2848, signed by an elected corporate officer (and not a "vanity titled" officer) designating the employee.

An employee so designated on the Power of Attorney is subject to OPR jurisdiction, the article concludes. It then goes on to inform the IRS LB&I agents the procedures to follow to make a referral of actionable conduct to the OPR.

Section: Judicial Estoppel
Taxpayer Who Agreed to Exact Amount of Evaded Tax in Plea Agreement Could Not Challenge Amount in Civil Action

Citation: Mirando v. Commissioner, CA6, 2014 TNT 174-13, 9/8/14

In the case of *Mirando v. Commissioner*, CA6, 2014 TNT 174-13, the Sixth Circuit clarified the application of the decision in the case of *United States v. Hammon*, 277 F. App'x 560 (6th Cir. 2008) where a taxpayer who had plead guilty to illegally avoiding. In the *Harmon* case the Sixth Circuit had allowed the taxpayer to nevertheless dispute the accuracy of the IRS's civil tax assessment.

The Court found that Mr. Mirando, unlike the taxpayer in *Hammon* could not pursue his claim.

The Court noted that in the *Hammon* case the taxpayer had plead guilty to evading taxes of approximately $2.39 million. The court found that because the agreement did not specify the exact amount of taxes due, the taxpayer was not judicially estopped from disputing the exact amount of taxes due. The Court specifically noted that the government, having drafted the plea agreement, could have specified the exact amount of tax due as part of the plea agreement but did not do so.

However, the Court found differences in Mr. Mirando's plea. The Court noted:

> In contrast, Mirando's plea agreement unequivocally states that the government would have proven beyond a reasonable doubt at trial that Mirando owed precisely $448,776.13. There is no approximation -- the language that the government drafted explicitly stated that Mirando was

> stipulating to the numerical accuracy of the assessment, and Mirando agreed to the stipulation by initialing the page and signing and entering the plea agreement.

Or, to put it more precisely, the government took the Sixth Circuit's advice and had the exact amount specified.

The Court noted that Mr. Mirando did receive a benefit from entering into this agreement with the amount specified. It noted:

> Mirando would derive an unfair advantage if not estopped from asserting his tax refund claim because he pleaded guilty and stipulated to the tax assessment in order to ensure that his family would not be prosecuted. Mirando argues that this "putative benefit" did not accrue to him and that nothing in the record suggests that this benefit was the result of his agreement to the accuracy of the tax assessment. Yet Mirando has admitted on appeal, albeit inadvertently, that it did benefit him to include this provision of the plea agreement:
>
> > Fearing that his two children or ex-wife would be criminally prosecuted, [Mirando] entered into a plea agreement with the United States and [pleaded] guilty to all five counts in the indictment on August 21, 2007.
>
> Forgoing prosecution of Mirando's family was not a benefit to the government, but in fact was a detriment. Therefore, the provision must be a benefit to Mirando; otherwise, it would not have been included in the agreement and would not have been his admitted motivation for entering it.

Section: Scams
IRS Issues Warning About Phone Scams

Citation: News Release 2014-84, 8/28/14

Phone scams by individuals claiming to be calling from the IRS are increasing, and the IRS has issued News Release 2014-84 to help inform taxpayers how to defend themselves against these scams.

The text of the news release is provided below:

> The Internal Revenue Service issued a consumer alert today providing taxpayers with additional tips to protect themselves from telephone scam artists calling and pretending to be with the IRS.
>
> These callers may demand money or may say you have a refund due and try to trick you into sharing private information. These con artists can sound convincing when they call. They may know a lot about you, and they usually alter the caller ID to make it look like the IRS is calling. They use fake names and bogus IRS identification badge numbers. If you don't answer, they often leave an "urgent" callback request.
>
> "These telephone scams are being seen in every part of the country, and we urge people not to be deceived by these threatening phone calls," IRS Commissioner John Koskinen said. "We have formal processes in place for people with tax issues. The IRS respects taxpayer rights, and these angry, shake-down calls are not how we do business."
>
> The IRS reminds people that they can know pretty easily when a supposed IRS caller is a fake. Here are five things the scammers often do but the IRS will not do. Any one of these five things is a tell-tale sign of a scam. The IRS will never:
>
> 1. Call you about taxes you owe without first mailing you an official notice.

2. Demand that you pay taxes without giving you the opportunity to question or appeal the amount they say you owe.
3. Require you to use a specific payment method for your taxes, such as a prepaid debit card.
4. Ask for credit or debit card numbers over the phone.
5. Threaten to bring in local police or other law-enforcement groups to have you arrested for not paying.

If you get a phone call from someone claiming to be from the IRS and asking for money, here's what you should do:

- If you know you owe taxes or think you might owe, call the IRS at 1.800.829.1040. The IRS workers can help you with a payment issue.
- If you know you don't owe taxes or have no reason to believe that you do, report the incident to the Treasury Inspector General for Tax Administration (TIGTA) at 1.800.366.4484 or at www.tigta.gov.
- If you've been targeted by this scam, also contact the Federal Trade Commission and use their "FTC Complaint Assistant" at FTC.gov. Please add "IRS Telephone Scam" to the comments of your complaint.

Remember, too, the IRS does not use unsolicited email, text messages or any social media to discuss your personal tax issue. For more information on reporting tax scams, go to www.irs.gov and type "scam" in the search box.

Additional information about tax scams are available on IRS social media sites, including YouTube and Tumblr where people can search "scam" to find all the scam-related posts.

Advisers should consider providing information on these scams and the IRS's five "tell tale" signs of a scam to their clients.

Unfortunately many clients (especially older ones) may be susceptible to such scams, as they may assume that since the approach isn't coming via an electronic system it must be real. As well, they may be less aware of the ease with which personal information may be obtained about individuals in today's information age, and thus quickly convinced the caller must be "real" when they provide personal information.

CPAs should advise their clients that they should immediately contact the CPA if approached by someone claiming to be from the IRS and, if they really decide they are going to handle it (as some will convinced the CPA is going to charge them "too much" to handle the issues) they should hang up and make a call directly to the IRS at the 1-800-829-1040 number.

Similarly, a CPA might consider advising clients that the same rules should be applied to any call from any organization (such as their bank, brokerage firm, etc.) asking for such information. Simply hang up and call the organization back at a number you find independently (such as on their statement or the back of their credit card) to continue to deal with the supposed situation.

Section: Bankruptcy
Taxpayer Found to Have Willfully Evaded Tax in Purchasing Marketed Tax Shelter, No Discharge of Tax in Bankruptcy

Citation: In re: Vaughn, CA 10, 114 AFTR 2d ¶ 2014-5191, 8/26/14

In the case of *In re: Vaughn*, CA 10, 114 AFTR 2d ¶ 2014-5191, http://www.ca10.uscourts.gov/opinions/13/13-1189.pdf, the Tenth Circuit found a taxpayers' acquisition of a marketed tax shelter that later was successfully challenged by the IRS was the filing of a fraudulent return with a willful intent to evade tax, a finding that meant the tax due was not dischargeable in the taxpayer's Chapter 11 bankruptcy.

Pursuant to 11 USC 523(a)(1)(C) income taxes are not dischargeable in a Chapter 11 bankruptcy if the tax is with respect to a return that was fraudulent or where the taxpayer willfully intended to evade the payment of a tax.

Mr. Vaughn had purchased a marketed tax shelter from an international accounting firm. The shelter was meant to offset a large multi-million dollar gain he had triggered from the sale of his business.

The shelter was a BLIPS shelter that, like many others begin pushed around that time, involved generating paper losses for tax purposes based on options in foreign currency. At the time Mr. Vaughn entered into the transaction he knew he was going to withdraw within 60 days, virtually assuring that there would be no realistic chance of an economic gain from the transaction except from the promised tax benefits.

The taxpayer signed an engagement letter with the firm acknowledging that the transaction was aggressive and that the IRS could challenge it. While the letter indicated that the firm believed there was a greater than 50 percent change the position would be sustained if challenged by the IRS, it also would not guarantee any tax results. As the taxpayer understood the matter, engaging in the transaction (for a $506,000 fee) would reduce his taxes on the transaction from $9 million to $3 million.

The transaction generated a purported tax loss of $42 million, although he reported less than the full $42 million loss on his return for the year in question. In his deposition he admitted he did so on the advice of a member of the international accounting firm who suggested that by doing so he'd be less likely to arose suspicion. At trial he changed his answer to this question, but still admitted when he signed his 1999 tax return he knew he had not suffered an economic loss that corresponded to the claimed tax loss.

The IRS issued Notice 2000-44 in September 2000 that described generally this sort of transaction as one that the IRS would not recognize losses from. The accounting firm provided the taxpayer with a copy of the notice in February of 2001.

Another executive with the company who also participated in the transaction informed the taxpayer that this other executive was being audited by the IRS on the transaction. As well, the accounting firm in February 2002 told the taxpayer that it was being examined and suggested he enter into the voluntary disclosure program.

Despite this bad news, the taxpayer (following a divorce early in 2001) went on a spending spree with his new spouse, spending money fairly freely from the date he become involved with this person in April 2001 until the couple divorced in March 2003. That included purchasing his new romantic interest a BMW, paying $1.73 million cash for a new home he then titled in his then fiancé's name, put $1.5 million into an irrevocable trust for his new step-daughter, and generally lived the "good life" during the short duration of the marriage.

The taxpayer had entered into the voluntary program for the participants in the transaction. He was informed his ex-spouse had filed for innocent spouse relief from the liability. He argued against this, pointing out that she had received significant assets in the divorce and while he had $10 million in assets after that divorce, his worth had now dropped to $4 million following his second divorce. Thus, he claimed, if held responsible for the entire tax (set at just under $9 million) he would be bankrupt.

The bankruptcy court found that the taxpayer had both filed a fraudulent return and had willfully evaded his taxes, thus refusing to discharge the tax assessment in his Chapter 11 bankruptcy. The U.S. District Court that heard the first appeal sustained the Bankruptcy Court.

The taxpayer argued that he had "merely" been negligent with regard to his tax liability but had not acted willfully.

The Bankruptcy Court noted that a finding of willful evasion required finding of two discrete elements—a conduct requirement and a mental state requirement.

The Bankruptcy Court (in analysis sustained by the Court of Appeals) found that the taxpayer's actions demonstrated his state of mind rose to the level of willfully evading the tax. The Court found that he had undertaken behavior at odds with his clearly demonstrated business acumen in participating in the BLIPS transaction and that he had depleted his assets while fully aware that it was highly likely there would be a significant tax liability assessed. The Court found his conduct, given his knowledge of the impending tax assessment, met the conduct requirement for willful evasion as well.

The Appellate Court rejected the taxpayer's claim that his dispositions of assets prior to an IRS assessment should not count against him. The Court did not agree, finding that a taxpayer's action when he/she knows of an investigation which is likely to result in a significant assessment can be used to establish willfulness for these purposes. So long as he was aware of the anticipated tax obligation, his actions to divest himself of assets will be used against him.

The Court also did not find believable his claim that he innocently relied upon the international firm's advice.

The Court rejected the taxpayer's additional argument that he must be found "merely negligent" due to the Tenth Circuit's decision in the case of *Blum v. Commissioner*, 737 F.3d 1303 (10th Circuit 2013). In that case the Court had sustained a lower court finding that the taxpayer was subject to a negligent underpayment penalty for participating in the same transaction. The taxpayer argued that this case established that participants in this shelter are "merely negligent" and thus he could not be held to have acted willfully.

The Court found the taxpayer was reaching far beyond what the case had actually held. The finding that *Blum*'s conduct was sufficient to support a finding to sustain a negligence penalty does mean that this taxpayer's conduct (or even that of the taxpayer in *Blum*) would not rise to the level of willfulness.

Thus, the Court affirmed the holding that the taxes could not be discharged.

The problem in this case is, effectively, the Court found that the taxpayer "should have known" this deal was too good to be true. That was based on his business acumen and knowledge there was no economic loss. As well, his actions from the time he learned it was likely his return would be examined and a large tax liability assessed certainly looked like those of a person who was not "saving up" the funds to take care of that tax liability, but rather was burning through assets so that they would not be available to pay that tax.

Section: OPR
Contingent Fee Rule in Circular 230 Struck Down, Provisions Regulating Preparation by CPAs Brought into Question

Citation: Ridgely v. Lew, et al, USDC DC, No. 1:12-cv-00565, 2014 TNT 138-11, 7/16/14

IRS attempts to regulate tax practice ran into another stumbling block courtesy of the United States District Court for the District of Columbia, the same venue from which emanated the *Loving* decision. This time, though, the issue involved traditional Circular 230 preparers and the revisions made in 2007 to Circular 230 §10.27 that greatly restricted the circumstances under which CPAs, EAs and attorneys could prepare amended income tax returns for a fee contingent on the tax recovery obtained.

In the case of *Ridgely v. Lew, et al*, USDC DC, No. 1:12-cv-00565, 2014 TNT 138-11 a CPA argued that the IRS had overstepped its authority to regulate tax practice when it issue those revised regulations seven years ago.

Mr. Ridgely had been part of another decision last year where the same court had denied a claim that Circular 230 violated the U.S. Constitution's guarantees on freedom of speech and right to petition the government (*Ryan LLC v. Lew, et al*, 111 AFTR 2d 2013-1453). But this time the Court proved more sympathetic to his arguments.

The decision uses an analysis very similar to the one applied in the *Loving* case where the Court found that 31 USC §330's limits on representation before the IRS does not extend to preparing returns. In this case the court found the same was true regarding refund claims.

The Court notes:

> 26 U.S.C. § 7701 expressly defines "tax return preparer" to include individuals who prepare tax returns or tax refund claims. 26 U.S.C. § 7701(a)(36). Beyond grouping tax-return preparers and tax-refund preparers in the same statutory definition, Congress enacted a comprehensive scheme of penalties to curb the potential for abuse in the preparation and filing of both original returns and refund claims. See 26 U.S.C. §§ 6662, 6663, 6676, 6694, 6701, 7206, and 7207 (penalizing filing frivolous claims for refunds, inaccurate reporting, fraud, understatements due to unreasonable positions, willful or reckless conduct, aiding and abetting understatements of tax liabilities, willfully aiding or assisting in the preparation of fraudulent or false claims, and willfully delivering fraudulent or false returns to the IRS). These provisions reveal that Congress conceived of tax-return preparation and tax-refund preparation as similar activities that qualitatively differ from the "practice" of presenting or adjudicating cases. But under the IRS's view, these specific provisions would serve no purpose, for Section 330 itself would have given the IRS liberal authority to impose various penalties on tax-return preparers who behave unethically. See Loving, 742 F.3d at 1020. The definition of "tax return preparer" and the need to avoid surplus age support the conclusion that Congress differentiated between the preparation and filing of refund claims on the one hand and their subsequent adjudication on the other. Congress clearly intended to allow the IRS to regulate these two categories of activity differently, and the grant of authority in Section 330 is limited to the latter.

More troublesome to the IRS (and the Office of Professional Responsibility in particular) is the Court's analysis of the IRS's long standing position that once a person becomes a Circular 230 practitioner (generally by submitting a power of attorney to represent a client) the IRS gains broader powers to regulate the individuals' tax practice generally. The Court did not find much positive to say about that position.

The Court noted:

> First, it is inconsistent with the use of the word "practice" in Section 330. The statute does not regulate "practitioners" generally; it regulates a specific kind of activity they may undertake: "practice . . . before the [IRS]." 31 U.S.C. § 330(a)(1). Second, the IRS's position would read the word "representative" out of Section 330. As Loving made clear, Section 330 only applies to individuals when they represent taxpayers. Third, adhering to the IRS's position would lead to absurd results. According to the IRS, it could broadly regulate the actions of CPAs no matter what they were doing -- even if their conduct was nowhere close to "practicing" before IRS -- simply because, say, the CPAs "practiced" before the IRS once a year. Meanwhile, the IRS would impose no contingent fee restrictions on the preparation and filing of Ordinary Refund Claims by non-CPAs and those who never "practice" before the IRS. Nothing in the statutory text (or, for that matter, the context and history of Section 330) gives the IRS this kind of authority over CPAs specifically. Further, nothing in Section 10.27 indicates that the IRS was concerned with CPA conduct in particular instead of with the ethics of fee arrangements for preparation and filing generally. The Court therefore disagrees with the IRS that simply because CPAs may at times practice before the IRS, the IRS has authority to regulate their conduct without limit.

As a practical matter this decision may be more significant for CPAs than the *Loving* decision, as it brings into question any provision of Circular 230 that attempts to regulate a CPA outside the context of “pure” representation before the IRS.

However, CPAs should remember that many of Circular 230’s tax preparation provisions are duplicated either in the Internal Revenue Code itself (such as at §6694 for tax return positions) and the AICPA *Statement of Standards for Tax Services*. In fact, the existence of IRC provisions regulating preparers is one of the key reasons given by the Court for denying the IRS the right to impose such regulations under Circular 230.

Section: OPR

IRS Unveils Voluntary Tax Preparer Registration Program Despite Complaints of AICPA and NAEA, AICPA Files Unsuccessful Suit to Block While National Taxpayer Advocate Praises the Program

Citation: Revenue Procedure 2014-42, 6/30/14, AICPA Lawsuit Filing, 7/15/14 and Dismissal 10/28/14 (114 AFTR 2d ¶2014-5386), National Taxpayer Advocate's Objectives Report, 7/16/14

The IRS unveiled a new voluntary Annual Filing Season Program in response to the Service’s loss in the case of *Loving v. IRS,* 742 F.3d 1013,113 AFTR 2d 2014-867, (D.C. Cir. 2014) in its attempt to provide a mandatory preparer licensing program. The details of the new program are found in Revenue Procedure 2014-42, http://www.irs.gov/pub/irs-drop/rp-14-42.pdf. The program has drawn both praise and criticism (including the filing of a lawsuit to block its implementation).

The program is designed for preparers who not attorneys, CPAs or enrolled agents—what are referred to as “unenrolled preparers” generally. The ruling revokes, effective for returns and claims for refunds signed after December 15, 2015, Revenue Procedure 81-38.

That Revenue Procedure allowed unenrolled preparers to represent taxpayers in examination if they had prepared and signed the return under examination. Such individuals could not represent taxpayers beyond that level, including at appeals.

The new program will restrict this limited representation only to those unenrolled preparers who have an "Annual Filing Season Program Record of Completion" for calendar year in which the return was prepared and signed and for the year in which representation occurs. Thus, unenrolled preparers who wish to appear with their clients for exams will need to enter into this program and remain qualified under it.

The ruling notes that it "does not in any way affect or limit the ability of attorneys, CPAs, or EAs to represent taxpayers before the IRS. The rules governing the practice of such persons before the IRS are set forth in Circular 230." Or, to put it more directly, such individuals will not need to complete the Annual Filing Season Program in order to represent individuals in examinations.

The program will require individuals who wish to obtain the "Annual Filing Season Program Record of Completion" to complete an approved 6 hour federal tax refresher course each year and pass a written exam on the material in the course, scoring at least 70% on such an exam. Some individuals are exempted from having to take the exam. Those include:

- CPAs, EAs and attorneys;
- Individuals that passed the original RRTP examination;
- Tax return preparers licensed by a state or territory

As well, applicants must complete 18 hours of approved continuing education courses in the year prior to the application. This education must consist of 2 hours of ethics, 10 hours of federal tax law topics and 6 hours of federal tax updates. Those exempt from the 6 hour refresher course requirement must complete 15 hours of approved continuing education, with the main difference being that the tax update component is reduced to 3 hours.

Individuals entering this program must consent to the applicability of the provisions of Circular 230 governing representation before the IRS for the entire period covered by the Record of Completion.

Certain individuals are barred from the program (those not current in their filing obligations, those disbarred, suspended or disqualified from practice under Circular 230, etc.).

Individuals who obtain the Record of Completion are limited in how they advertise their achievement. Specifically the ruling holds:

> A tax return preparer who receives a Record of Completion may not use the term "certified," "enrolled," or "licensed" to describe this designation or in any way imply an employer/employee relationship with the IRS or make representations that the IRS has endorsed the tax return preparer. A tax return preparer who receives a Record of Completion for a calendar year may represent that the tax return preparer holds a valid Annual Filing Season Program Record of Completion for that calendar year and that he or she has complied with the IRS requirements for receiving the Record of Completion.

The program garnered an immediate negative response from the AICPA (http://www.aicpa.org/press/pressreleases/2014/pages/irs-proposed-voluntary-program-for-tax-preparers-is-unlawful-and-improper-says-aicpa.aspx). The AICPA called the program "unlawful and improper" in their news release.

The new release, citing a letter the AICPA sent to the IRS, makes the following points:

- First, no statute authorizes the proposed program;

- Second, the program will inevitably be viewed as an end-run around Loving v. IRS, (a federal court ruling rejecting an earlier IRS attempt to regulate tax return preparers);

- Third, the IRS has evidently concluded, in developing the proposed program, that it need not comply with the notice and comment requirements of the Administrative Procedure Act. This is incorrect; and

- Finally, the current proposal is arbitrary and capricious because it fails to address the problems presented by unethical tax return preparers, runs counter to evidence presented to the IRS, and will create market confusion.

The National Association of Enrolled Agents (NAEA) is also similarly unhappy with the program, also sending negative comments to the IRS about the program (http://www.naea.org/advocacy/comments-letters/Koskinen-voluntary-annual-preparer-certificate-program).

The use of the term "unlawful" caused many to believe that AICPA was going to file suit—and that belief was proved to be correct on July 15, 2014. On that date the AICPA filed suit, based on the points outlined in its letter, in the United States Federal District Court for the District of Columbia—a court that has dealt the IRS's tax return regulation apparatus two recent losses (the *Loving* case noted above and a later ruling on the issue of contingent fees in the *Ridgely* case the day after the AICPA filed its suit). The AICPA complaint was posted on their we bsite at http://www.aicpa.org/Advocacy/Legal/DownloadableDocuments/AICPA_v_IRS.pdf.

However, the IRS was successful in having the AICPA lawsuit dismissed. The ruling (*American Institute of Certified Public Accountants v. IRS, et al.*, DC Dist Col, 114 AFTR 2d ¶2014-5386) held that the AICPA did not have standing to challenge the program.

However not all parties are complaining about the program. In her mid-year National Taxpayer Advocate's Objectives Report issued the same week the AICPA filed suit, the Taxpayer Advocate praised the IRS's attempts to impose standards on unenrolled preparers (http://www.taxpayeradvocate.irs.gov/userfiles/file/FY15-Full-Report/IRS-Steps-to-Create-a-Voluntary-Program-for-Tax-Return-Preparer-Standards.pdf). This isn't surprising as the Taxpayer Advocate had called for just such a voluntary program in her report last year.

However the Taxpayer Advocate continues to call for Congressional action to require regulation of all tax preparers under a system similar to the one thrown out by U.S. District Court for the District of Columbia in the *Loving* case.

Section: 31 U.S.C. 9701
Installment Agreement and Offer in Compromise Fees Increased for 2014

Citation: TD 9647, 12/2/13

Fees for installment agreements and applications for offers in compromise were revised by the IRS in TD 9647, https://s3.amazonaws.com/public-inspection.federalregister.gov/2013-28863.pdf. The revised fees take effect on January 1, 2014.

The new fees are:

Description	Fee Before January 1, 2014	Fee On and After January 1, 2014

Entering into an installment agreement	$105	$120
Restructuring or reinstating an installment agreement	$45	$50
Processing an offer in compromise application	$150	$186

The special reduced rates for low income taxpayers will continue to apply as before. As well, the $52 fee for entering into a direct debit installment agreement also will remain unchanged.

Section: Circular 230
Ex-CPA Disbarred for Actions Not Directly Related to Tax Practice

Citation: OPR v. Christensen, ALJ Docket 12-IRS-0003,

A former CPA failed in his argument that the OPR should not be able to prevent him from obtaining a PTIN (and thus not be able to prepare tax returns) for conduct not directly related to tax practice. In the ALJ decision in the case of OPR v. Christensen, (http://www.irs.gov/pub/irs-utl/Redacted%20Final%20Order%20Assessing%20Sanction%20-%20IRS%20Christenson.pdf), the individual had been convicted of theft from his daughter's trust account.

The matter arose as part of a family dispute for the preparer in question. Eventually his litigation with his family resulted in $90,000 being awarded to a trust to benefit his daughter. The preparer ended up moving $75,000 of those funds into a personal account and then day-trading the funds unsuccessfully, losing $14,000. As well, he claimed $15,000 of the funds represented costs he had incurred in the litigation.

The family feud continued, with the daughter now pursuing the father for misconduct regarding her trust fund. In the end the preparer settled with his daughter on her civil complaint, but also ended up with a felony conviction. Both the states of Washington and Oregon revoked his CPA license.

The preparer sought to obtain a PTIN to be able to prepare returns, but the OPR decided that he should instead be disbarred. He filed an appeal and his case came before an administrative law judge.

The preparer noted that this issue was a "family matter" and did not arise from his tax practice. He pointed out he had been in practice for many years, and had never had a disciplinary problem with the OPR during that time. He also noted that he was inexperienced with trust issues which contributed to his problems. Finally, he claimed that his age (61) and medical issues should serve as mitigating factors.

The OPR, or more specifically the OPR's Director Karen Hawkins, disagreed. Karen, OPR's sole witness in the hearing, argued that the revocation of his CPA certificate by a state (not to mention two) was, by itself, disreputable conduct under Circular 230 §10.51. She noted that the states had each concluded his conduct justified right to practice as a CPA, and the same factors argued for denying him the right to practice in tax matters.

His inexperience with trust issues was an aggravating, rather than mitigating, factor, since he took on a professional engagement for which he was not competent. Karen also noted that he had claimed, when his daughter began her actions, a right to be paid for professional services as part of the trust accounting. Thus, she noted, he seemed to swing between claiming he was acting as a professional or "merely as a family member" as seemed to best serve his interests in the matter he was currently in hot water for.

The administrative law judge sided with the OPR, noting:

> In sum, Respondent failed to exercise any sort of reasonable judgment in his dealings with his daughter's money. Respondent's conduct reflects extremely poorly on his ability to comport himself under the requirements of Circular 230.

Thus, the disbarment of the practitioner was sustained.

Section: Various
IRS Releases Taxpayer's Bill of Rights

Citation: News Release IR 2014-72, 6/10/14

The IRS announced in News Release IR 2014-72 (http://www.irs.gov/pub/irs-news/IR-14-072.pdf) a “Taxpayer’s Bill of Rights” that is to be added to Publication 1, “Your Rights as a Taxpayer” and highlighted on the IRS website.

The list of rights provided in the release are:

1. The Right to Be Informed
2. The Right to Quality Service
3. The Right to Pay No More than the Correct Amount of Tax
4. The Right to Challenge the IRS’s Position and Be Heard
5. The Right to Appeal an IRS Decision in an Independent Forum
6. The Right to Finality
7. The Right to Privacy
8. The Right to Confidentiality
9. The Right to Retain Representation
10. The Right to a Fair and Just Tax System

This does not actually add or change any rights for the taxpayer, but rather serves as an educational tool for the IRS to help taxpayers understand the system and how it works.

Section: Circular 230
Revisions to Circular 230 Eliminate Covered Opinion Rules and Expand General Written Advice Provisions of Circular 230

Citation: TD 9688, 6/12/14

In TD 9668 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-13739.pdf) the IRS adopted, with minor changes, the revisions proposed in 2012 in REG-138367-06 (http://www.gpo.gov/fdsys/pkg/FR-2012-09-17/pdf/2012-22836.pdf).

The regulations make significant revisions to the written advice provisions of Circular 230. The regulations removed the covered opinion rules found in the prior version of §10.35 and substituted a new due diligence requirement in the §10.35 slot, and beefed up the general written advice rules found in §10.3.

In the preamble to the proposed regulations, the IRS discussed the primary reasons for the removal of the old covered opinion rules of current §10.35. The IRS believes the rules added significantly to the cost and complexity of the provision of certain advice without a corresponding benefit to taxpayers. As well, other measures have served to bring under control the types of tax shelter promotion related advice that the covered opinion rules were meant to address.

The IRS also believes that the standards imposed by the recently revised §10.36 serve to reduce the risk that an adviser would be giving advice of the type the IRS was attempting to eliminate under the covered opinion regime of §10.35. §10.36 as it now exists imposes an obligation on any individuals responsible for a firm's tax practice to insure the firm has appropriate procedures to insure all individuals in the firm comply with Circular 230 and to take prompt action if he/she becomes aware of noncompliance that, despite the controls, manages to occur in the firm.

The IRS also suggests that it believes advisers were greatly overusing the disclaimer language for reliance opinions found in §10.35, routinely inserting it into emails and letters regardless of whether the documents dealt with tax matters that would have required a covered opinion or even if the document contained any tax related advice or material at all. As the proposed regulation eliminates the entirety of current §10.35, it will also remove the disclaimer provision. The IRS indicates that this should eliminate the use of such disclaimers by preparers, as such a disclaimer has no impact under either current or proposed §10.37.

Old §10.35 is replaced with a new and essentially unrelated §10.35 that provides for explicit competence standards that are similar to those imposed under the AICPA Code of Professional Conduct. The rule requires that a practitioner must possess necessary competence to engage in practice before the IRS. The regulation defines such competence as "the knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged."

As Circular 230 applies to each individual preparer, this would impose a requirement that each professional must conclude on each assignment given to that professional that he/she has the necessary knowledge and skill before agreeing to be "engaged" to take on the assignment in question. This requirement is very similar to that found in the due professional care standards in the AICPA Code of Conduct, which also applies at the individual accountant level.

§10.37 is expanded significantly over its predecessor, though maintaining much of the same tone. The provisions here are now less rules based than the old §10.35 rules, but rather require the use of professional judgment to apply the concepts. That is, don't expect to find "bright lines" here that are mechanically applied—rather, the professional will have to justify his/her conduct by applying the overall principles discussed.

The section covers all written advice provided by the practitioner and will presumably continue to cover not just letters, but also emails, faxes and any other non-oral communication of the practitioner to the client. Specifically, when giving advice a practitioner must, under the revised provisions:

- Base the written advice on reasonable factual and legal assumptions (including assumptions as to future events);
- Reasonably consider all relevant facts that the practitioner knows or should know;
- Use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter;
- Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable;
- Relate applicable law and authorities to facts; and
- Not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

Unlike the old §10.35 provisions, there is no specific requirement here to include a detailed discussion of all relevant facts—rather, the preamble makes clear, the amount of detail needed in the advice will be determined based on all relevant facts. However, regardless of whether the advice discusses all the facts, the CPA must still show that he/she considered all relevant facts (including determining just what are the relevant facts that would impact the advice) and any assumptions were reasonable.

The revision removed the old prohibition on considering whether an issue would be resolved through settlement if raised. The IRS has decided that prohibiting such considerations greatly complicated providing advice and also ran afoul of competing ethical responsibilities of the professional to the client.

The provision goes on to discuss a professional's ability to rely on the advice of others, following similar rules found in the provisions related to the preparer penalty regulations under IRC §6694. A practitioner can only rely on the advice of others if the advice is reasonable and the reliance is in good faith. Reliance is deemed not to be reasonable when:

- The practitioner knows or should know that the opinion of the other practitioner should not be relied on;
- The practitioner knows or should know that the other practitioner is not competent or lacks the necessary qualifications to provide the advice; or
- The practitioner knows or should know that the other practitioner has a conflict of interest as described in this part

Generally the first bullet describes a case when the adviser, seeing the advice of the other adviser, does not agree with its conclusion. In such a case, the adviser would know that the advice should not be relied upon.

The second standard requires that the adviser consider the qualifications of the adviser upon whose advice he/she is relying. Thus, an adviser would need to consider what type of qualifications an individual should possess to give such advice and then determine if this person meets those qualifications. Similarly, if the adviser is aware of a lack of competence on the part of that adviser, the adviser cannot rely on that advice.

The final provision may prove the most problematical. Note that the rule covers any conflict of interest and that would include a conflict that the taxpayer may have given informed consent to.

Specifically, if a promoter of a certain transaction provides the taxpayer with an analysis of the tax positions inherent in the transaction prepared by the promoter's legal counsel, the adviser would not be reasonable in relying on that opinion. Rather the adviser would need to independently determine the validity of that position, and the adviser would be considered directly responsible for the advice on that position.

As is true under the prior §10.37, the revised §10.37 imposes a greater duty of care if the adviser believes the advice will be provided to third parties. However, it goes on to borrow language from old §10.35, imposing the heightened standard on opinions where the adviser knows or has reason to know the opinion will be used "in promoting, marketing, or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code…" That language exists in current §10.35 as the trigger for determining the need for a reliance opinion.

The regulations took effect on June 12, 2014.

Section: FBAR Reporting
Online Poker Accounts Found by District Court to Be Accounts Subject to FBAR Reporting

Citation: United States v. Hom, US DC ND California, Case No. C 13-03721 WHA, 113 AFTR 2d ¶ 2014-893, 6/4/14

Accounts a taxpayer had with online poker operations were found to be bank accounts subject to FBAR reporting in the case of *United States v. Hom*, US DC ND California, Case No. C 13-03721 WHA, 113 AFTR 2d ¶ 2014-893.

The case turned on whether funds held by three online poker operations, incorporated and operated outside the United States, were "other financial accounts" as defined by 31 CFR 103.24. While noting the Ninth Circuit (which would hear any appeal) had not directed ruled on that issue, the Court found persuasive the opinion of the Fourth Circuit in the case of *Clines,* (CA 4 1992) 958 F2d 578.

The opinions notes:

> Under Section 5312(a)(1), a "person acting for a person" as a "financial institution" or a person who is "acting in a similar way related to money" is considered a "financial agency." Section 5312(a)(2) lists 26 different types of entities that may qualify as a "financial institution." Based on the breadth of the definition, our court of appeals has held that "the term "financial institution" is to be given a broad definition." *United States v. Dela Espriella*, 781 F.2d 1432, 1436 (9th Cir. 1986). The government claims that FirePay, PokerStars, and PartyPoker are all financial institutions because they function as "commercial bank[s]." Section 5312(a)(2)(B). The Fourth Circuit in *Clines* found that "[b]y holding funds for third parties and disbursing them at their direction, [the organization at issue]*functioned* as a bank [under Section 5314]." *Clines*, 958 F.2d at 582 (emphasis added).
>
> So too here. Defendant admits that he opened up all three accounts in his name, controlled access to the accounts, deposited money into the accounts, withdrew or transferred money from the accounts to other entities at will, and could carry a balance on the accounts (Hom Dep. at 38, 40, 45–46, 110, 116). As FirePay, PokerStars, and PartyPoker functioned as banks, defendant's online accounts with them are reportable.

The Court also did not accept the taxpayer's argument that while these entities might be based offshore, they did have bank accounts in the United States, making it possible the taxpayers funds were not located offshore.

The Court found:

> It is irrelevant where PokerStars, FirePay, or PartyPoker opened their bank accounts. Those accounts belong to them, not defendant. Rather, *his* accounts are digital constructs that these financial institutions, all located outside of the United States, created and maintained on his behalf.

The taxpayer argued that the IRS's instructions to the 2010 FBAR reporting form disagreed with that, noting they stated "[t]he geographic location of the account, not the nationality of the financial institution in which the account is found determines whether it is an account in a foreign country."

The Court first noted that instructions are not binding on the government and therefore cannot be relied upon to support his position. As well, the Court found that while taxpayer may have claimed to show it was *possible* his funds could have been held in the United States, he never demonstrated such funds actually were held onshore.

The Court therefore sustained the IRS in its assessment of penalties against the taxpayer for the non-willful failure to report these accounts on an FBAR reporting form.

Section: FBAR Reporting
Jury Finds Taxpayer Guilty of Willful Failure to Report Foreign Account, Taxpayer Faces Potential Penalty of Approximately 150% of Maximum Value of Account

Citation: Department of Justice News Release, United States v. Carl R. Zwerner, Case # 1:13-cv-22082-CMA, 5/28/14

The US Department of Justice issued a press release detailing a government victory in pursuing the civil penalties for willful failure to report an interest in a foreign bank account in the Carl Zwerner case (http://www.justice.gov/tax/2014/txdv14575.htm).

Mr. Zwerner was found by the jury to have willfully omitted information related to Swiss bank accounts in each year from 2004 through 2006. The balance of the account in each year exceeded $1.4 million. The statutory penalty in this case is set at 50% of the high balance for each year in question, resulting in a penalty that appears to be about 150% of the maximum balance that was ever in the account.

While it's tough to know for sure what caused the jury to decide against Mr. Zwerner, the Justice Department press release emphasized that he had filled in an organizer provided by his accountant for the years in question and, on each organizer, had checked the "no" box in answer to the question if he had an interest in offshore bank accounts, as well as indicating he had no foreign income (turns out he did have such income—just didn't tell the accountant about it).

In a comment on the case on the California Society of CPA's TaxTalk discussion forum, it was indicated that the government's pleading in the case took the position that the taxpayer's failure to take part in any of the three voluntary offshore account disclosure programs in the recent past is evidence that he willfully attempted to avoid disclosing the existence of the accounts. Certainly it seems likely that, given the high profile nature of the various cases in this area, that the individual was aware he had a potential problem.

The accountant in this case may be lucky that the client had filled in the organizer and can be shown to have specifically lied to the accountant in the preparation of the return. If the client is given a "pass" on answering these questions because he/she just "doesn't bother" with filling an organizer, the CPA may find that if a problem crops up the client may to try and collect the penalty from the CPA, now suddenly claiming that the CPA failed to perform his/her duty and inform the client of the need to file the form.

As well, the OPR has indicated that the office believes that CPAs and other preparers have shirked performing the due diligence required under Circular 230 in inquiring as to the existence of foreign accounts. If a taxpayer manages to succeed in convincing a jury that he/she did not willfully fail to report and perhaps even has reasonable cause to avoid even the lower penalty, it seems very possible the IRS might turn its attention to the preparer.

CPAs must remember that while we can rely on a taxpayer's representations on a tax matter, we *must have a representation to rely upon.* Too often during the heat of tax season there's a temptation to "just get the return done" and assume any questions the taxpayer failed to answer in an organizer are not relevant. While understandable, that sort of procedure is a recipe for a potential malpractice and regulatory nightmare for the CPA involved.

Section: FBAR Reporting
Offshore Voluntary Disclosure Program Restarted by IRS With Higher Base Penalty, No Stated Deadline for Filing

Citation: News Release IR-2012-5, 1/9/12, IRS website FAQ, 8/26/13

In News Release IR-2012-5 the IRS announced the third round of its Offshore Voluntary Disclosure Program (OVDP). The latest version has similarities to the earlier versions of the program, but as was true with the second version the penalties are increased in the latest version.

The major provisions of the latest program are as follows:

- There is no set deadline to apply, but the IRS reserves the right to change the terms of program in the future. The news release specifically indicates the IRS may choose to increase penalties in the future for all taxpayers or certain classes or taxpayers. As well, the IRS reserves the right to end the program at any time.

- The standard penalty rises to 27.5% of the highest aggregate balance in foreign bank accounts/entities or value of foreign assets during the eight full tax years prior to the disclosure. In the 2011 program that maximum penalty was 25%.

- The reduced penalties remain at 12.5% and 5%, with the requirements for those reduced penalties also remaining the same as under the 2011 program. Thus, individuals whose maximum value of foreign bank accounts/entities or assets did not exceed $75,000 in any calendar year covered by the program (prior 8 years) will qualify for the 12.5% rate. The 5% rate is provided for foreign residents who meet certain requirements.

- Taxpayers who feel the penalties under this program are disproportionate to the violation can opt to go the examination route instead.

- Those entering the program must file all original and amended returns for the past eight years. The participants must pay all addition tax due for that period, as well as interest and penalties (accuracy related and delinquency).

As was true before, this program is designed for those with unpaid tax liabilities.

The initial 2012 program information did not include any details on what should be done by taxpayers who did not have unreported income, but who had solely failed to make their required FBAR filings. The IRS later updated the guidance on the webpage with "frequently asked questions" to clarify this issue.

The website provides the following question:

> 17. I have properly reported all my taxable income but I only recently learned that I should have been filing FBARs in prior years to report my personal foreign bank account or to report the fact that I have signature authority over bank accounts owned by my employer. May I come forward under this new program to correct this?

The IRS's answer to this inquiry states:

> The purpose for the voluntary disclosure practice is to provide a way for taxpayers who did not report taxable income in the past to come forward voluntarily and resolve their tax matters. Thus, if you

reported, and paid tax on, all taxable income but did not file FBARs, do not use the voluntary disclosure process.

For taxpayers who reported, and paid tax on, all their taxable income for prior years but did not file FBARs, you should file the delinquent FBARs according to the FBAR instructions and include a statement explaining why the FBARs are filed late. Through June 30, 2013, you may file electronically or by sending paper forms to Department of Treasury, Post Office Box 32621, Detroit, MI 48232-0621. After June 30, 2013, you must file electronically. If you are unable to file electronically, you may contact FinCEN's Regulatory Helpline at 1-800-949-2732 or (if calling from outside the United States) 1-703-905-3975 to determine possible alternatives for timely reporting.

The IRS will not impose a penalty for the failure to file the delinquent FBARs if there are no underreported tax liabilities and you have not previously been contacted regarding an income tax examination or a request for delinquent returns.

Non-resident taxpayers should also review the Filing Compliance Procedures for Non-Resident U.S. Taxpayers if they do not qualify for the procedures described in this FAQ.

NOTE: Taxpayers filing FBARs electronically do not currently have the technological ability to include a statement explaining why the FBARs are filed late. Until such time that they have the ability, it is sufficient to file the FBARs electronically, retain the statement, and submit the statement to the Service upon request.

The IRS provided related guidance for taxpayers who have reported all income but failed to file Form 5471 or Form 3520.

The question asked:

18. Question 17 states that a taxpayer who only failed to file an FBAR should not use this process. What about a taxpayer who only has delinquent Form 5471s or Form 3520s but no tax due? Does that taxpayer fall outside this voluntary disclosure process?

The IRS FAQ provides the following guidance in this situation:

A taxpayer who has failed to file tax information returns, such as Form 5471 for controlled foreign corporations (CFCs) or Form 3520 for foreign trusts but who has reported, and paid tax on, all their taxable income with respect to all transactions related to the CFCs or foreign trusts, should file delinquent information returns with the appropriate service center according to the instructions for the form and attach a statement explaining why the information returns are filed late. (The Form 5471 should be submitted with an amended return showing no change to income or tax liability.)

Include at the top of the first page of each information return "OVDI - FAQ #18" to indicate that the returns are being submitted under this procedure. This is very important to ensure your returns are processed through this procedure.

The IRS will not impose a penalty for the failure to file the delinquent Forms 5471 and 3520 if there are no underreported tax liabilities and you have not previously been contacted regarding an income tax examination or a request for delinquent returns.

Non-resident taxpayers should also review the New Filing Compliance Procedures for Non-Resident U.S. Taxpayers if they do not qualify for the procedures described in this FAQ.

The IRS will update information on this program on their website at http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-

Asked-Questions-and-Answers. The IRS has committed to updating its frequently asked questions and providing additional information.

Practitioners who have clients that inform them about potential offshore accounts and unreported income should be careful in handling such issues. Generally CPAs should initially refer such clients to a tax attorney for the initial discussion of facts, since information may be disclosed that the IRS might view as evidence of criminal tax evasion. As well, it is possible such offshore activities might have violated other U.S. laws outside the tax realm.

An attorney, with privilege in both civil and criminal matters, can be given this information and push the client to give a full confession of the facts. Once the attorney "clears" the client the CPA may be brought back in to deal with the actual filing. But the danger is that if the CPA goes forward and becomes aware of damaging information, the CPA may become a key witness against the client should prosecution later be undertaken. So care is needed in this area.

Section: 31
Voluntary Payment Designation That Designates Payment to Be Applied to Taxes of Another Taxpayer Must be Respected by IRS, IRS Announces Non-Acquiesence

Citation: Dixon v. Commissioner, 141 TC No. 3, 9/3/13, AOD 2014-01, 9/15/14

In the case of Dixon v. Commissioner, 141 TC No. 3 (http://www.ustaxcourt.gov/InOpHistoric/DixonDiv.Lauber.TC.WPD.pdf), the Tax Court eventually decided whether a voluntary payment designated by one taxpayer (Taxpayer 1) to pay the tax of another taxpayer (Taxpayer 2) has to be applied to the unpaid tax of Taxpayer 2. As well, is that true if Taxpayer 1 itself has unpaid taxes to which the payment can be applied.

When this matter first came before the Court, Judge Holmes answered in the negative to both questions, holding that the IRS was free to apply to payment to the outstanding liability of the taxpayer that actually made the payment. His decision on other issues in the case was published the same day (Dixon v. Commissioner, TC Memo 2013-207, http://www.ustaxcourt.gov/InOpHistoric/DixonMemo.Holmes.TCM.WPD.pdf) which granted credit to Taxpayer 2 for taxes actually withheld by Taxpayer 2. However, after reconsideration by the full Tax Court, the majority held that the IRS was required to apply the additional payment not of taxes actually withheld to Taxpayer 2's taxes and not assign the payment against the taxes of the taxpayer which actually sent in the payment.

In this case, "Taxpayer 1" was a corporation controlled by "Taxpayer 2" (the Dixons). The Dixons had their share of problems arising from taxes, including a plea agreement with the Justice Department in a case where they were criminally prosecuted for failing to file tax returns. Following that plea agreement, the Dixons' accountant determined they owed additional tax for the years in question. On the advice of their attorney, they contributed the cash to pay the tax to the corporation under a "constructive withholding" theory. They then sent separate checks for each taxpayer (Mr. and Mrs. Dixon), designating the payment as withheld income taxes applicable to a designated year for the designated employee.

While the IRS initially accepted this designation, the IRS later went back and changed the allocation since the corporation had large unpaid employment tax liabilities. Having done that, they sought to now collect the tax from the individual taxpayers for those payments that now had been designated to cover the corporation's liability.

The IRS first took the position that an employer could not years later "fix" a withholding problem and designate a payment as additional withholding under IRC §31 for the employee. The Tax Court agreed with that view.

However, the Court found this did not resolve the matter. The voluntary payment they had received from the corporation clearly indicated how the IRS was to apply the payment. The majority ruled that the IRS generally must respect voluntary payment designations, and that nothing limits that requirement to respect designations merely to taxes owed by the taxpayer who remits the funds.

Thus, the Court found that the IRS had to credit the accounts of the individual taxpayers for the payments in question and could not apply them to the unpaid tax of the corporation.

The IRS has announced that they will not follow this case in the future, releasing Action on Decision AOD-2014-01. Interestingly, the IRS pleads at the end of the AOD that they won't appeal the case due to its limited precedential nature—but they still felt the need to issue the AOD for this "limited value" case. Most likely the IRS's key concern is with the theory that a party can designate payments to be applied to another party and likely have a concern that the concept could be expanded beyond the limited case found in the *Dixon* matter.

Section: 446
Relief Granted for Late Filing of Form 3115 After Accidentally Left Off Electronically Filed Tax Return

Citation: PLR 201344001, 11/8/13

Electronic filing continues to create some unique quirks for advisers, especially when having to do certain unusual steps, such as occur when filing for an automatic change of accounting method. In such a case, a signed Form 3115 is to be sent with the tax return, along with a copy sent to the IRS National Office. Unfortunately in the electronic age, attaching the Form 3115 means scanning it and then attaching it to the electronic file.

In PLR 201344001 (http://www.irs.gov/pub/irs-wd/1344001.pdf) a tax adviser was required to seek relief for the taxpayer by asking for IRS permission to make a late election.

Under the procedures for obtaining automatic permission for an accounting method change, the taxpayer is required to attach a copy of the request to the original return. Unfortunately, if the copy is left off the return the taxpayer will have failed to comply with the automatic election provisions and will not have the necessary IRS consent to change its accounting method.

The problem is made more complicated by the mechanics of electronic filing. Modernized eFile allows for the attachment of PDF documents, but for the adviser that task is handled by their tax software.

For many advisers, attaching PDF documents is a relatively infrequent event. As well, in most cases the electronic transmission is simply pressing the appropriate button once the authorization is received, and the indication that the file has a PDF attachment may be subtle on the input screens and, even if an indication is there, it may not be clear exactly what PDF documents have been attached.

The IRS has been very willing to grant this relief, but it does come at a cost. First, there is the basic user fee that must be paid to the IRS. Second, there is both the time investment the adviser will need to put in to shepherd the request through the system and the simple problem of client relations when the error is discovered and communicated to the client.

Especially with the upcoming number of method requests to be generated due to the repair regulations, advisers should look into their procedures to assure they are not faced with asking for such relief.

Section: 481
Memorandum Explains How §481(a) Adjustments Have Effect of Including Items from "Closed" Years

Citation: Chief Counsel Advice 201442049, 10/17/14

Taxpayers and their advisers often talk about "closed" years in the context of taxes, often in the mistaken belief that once three years (or six years in some cases) have passed, any errors that might have existed previously cannot lead to a tax liability for the taxpayer. However, as Chief Counsel Advice 201442049 points out, when the issue involves an accounting method adjustment, the §481(a) has an unlimited ability to "reach back in time" and create a current tax liability.

The case in question involved issues of when a taxpayer should be reporting certain income from participation agreements. In this case, the advice was sought because exam was planning to conclude that the taxpayer had been erroneously deferring recognition of income on certain participation agreements. Exam believes that, in fact, the taxpayer should be recognizing this income currently as it was earned rather than deferring it until a later date when it would be paid.

However that creates a problem for exam—four year earlier (outside of the statue of limitations for assessing tax for the year) the taxpayer had earned a large sum in such an agreement but had not yet received the funds. If the taxpayer had properly reported the income in line with what the IRS believes is the proper reporting for such income, the entire amount would have been reported, and tax paid, in the year now closed to further assessment.

However, as the memorandum points out, the matter here is an accounting method and a change in that method. Generally accounting methods affect only the timing of income reporting, but not the ultimate amount be reported.

When a taxpayer changes his/her accounting method, a cumulative adjustment is computed and brought into income under §481(a) over a time period (most often four years beginning with the year of change). The cumulative effective (which for tax purposes is called the §481(a) adjustment) is the net difference between cumulative net income that would have been reported in total since inception under the new method over/under the amounts that had actually been reported.

Thus, even though a major part of that cumulative adjustment relates to a "closed" year, that amount will still come into income as part of the §481(a) adjustment. This is because, as was noted earlier, a year is "closed" only with respect to assessing a tax liability for that particular year. IRC §481(a) moves the income reporting into a year that is still available for assessment so there is no violation of the statute of limitations on assessments.

Section: 905
Tax Court Claims Jurisdiction to Determine if it Does Not Have Jurisdiction in Foreign Tax Credit Refund Matter

Citation: Sotiropoulos v. Commissioner, 142 T.C. No. 15, 5/5/14

Generally under IRC §6213 the IRS cannot assess tax until they have issued a notice of deficiency and given a taxpayer 90 days to file a petition in Tax Court challenging the proposed assessment. However, in some circumstances the IRS can bypass issuing the notice of deficiency (and the taxpayer's right to take the matter to the Tax Court before facing IRS actions to enforce payment).

Some of the cases where the IRS may move directly to assessment and collection of the liability include any amount a taxpayer reports on his/her return [IRC §6201(a)(1)], correction of mathematical or clerical errors on the taxpayer's return [IRC §6213(b)(1)], assessable penalties [IRC §§6671-6725] and termination and jeopardy assessments [IRC §§6851, 6852 and 6861].

In the case of Sotiropoulos v. Commissioner, 142 T.C. No. 15, http://www.ustaxcourt.gov/InOpHistoric/SotriopoulosDiv.Lauber.TC.WPD.pdf, the issue involved another section that allows the IRS to bypass the notice of deficiency, that found in IRC §905(c) related to taxpayers who receive a refund of foreign taxes for which the taxpayer had previously claimed a foreign tax credit.

IRC §905(c)(1)(C) applies to cases where the a foreign tax paid is refunded in whole or in part, authorizing immediate IRS action. Taxpayers are required to file an amended return notifying the IRS of the refund, at which point these procedures are triggered.

However in the case at hand the IRS was examining the taxpayer's returns for three years. The IRS was informed by UK authorities that the taxpayer had received UK income tax refunds in each of those years. Initially the IRS issued a notice of deficiency related to the additional tax, along with penalties. The taxpayer filed her petition in Tax Court, arguing that in fact there had not yet been a refund for these purposes because UK tax authorities were still reviewing her refunds (and thus she might lose some or all of the amounts she had already received) as well as her claim that the US/UK tax treaty provisions also affect the application of IRC §905.

About a year later the IRS apparently decided that it had made a mistake in issuing a notice of deficiency, and sought to instead move directly to assessment under IRC §905(c). The IRS asked the Tax Court to dismiss the taxpayer's petition for lack of jurisdiction. Because the IRS agreed the Tax Court would have jurisdiction on the penalty issues, the IRS agreed to drop the attempt to assess penalties if the Tax Court agreed that the petition should be dismissed.

The Tax Court, however, did not agree with the IRS that it had not jurisdiction here. The Court agreed that if a refund had been issued the Court did not have jurisdiction since IRC §905(c) would preclude, but the Court found that it did have the jurisdiction to determine if there had actually been a refund issued, a predicate to the IRS being able to move directly to assessment.

While the case is directed at the foreign tax credit issue alone, the Court's ruling has broader application in holding that the Court always retains jurisdiction to determine if all requirements triggering the removal of the need to issue a notice of deficiency have been met.

Section: 1001
Taxpayer's "Swap" Did Not Create Basis to Shelter Gain on Sale of Stock

Citation: Bruce v. Commissioner, TC Memo 2014-178, 9/2/14

In the case of Bruce v. Commissioner, TC Memo 2014-178, we have yet another failure for the taxpayer related to a marketed tax shelter that attempted to create basis out of thin air—and which, yet again, the Tax Court found failed to do so.

This case was a bit different than earlier partnership structures, this time attempting to create a derivative that, in theory, served to manufacture basis.

As is generally the case in such marketed shelters, the structure itself was a bit convoluted but, as was generally the case, the problem being addressed was a taxpayer who was going to trigger a large taxable gain on the disposition of an asset, in this case the taxpayer's business.

In this structure the taxpayer attempted to use a pair of offsetting arrangements. In this case the taxpayer effectively agreed to loan an organization $5.5 million, the fund of which he'd effectively receive via receiving a loan from that organization in the same amount. The agreement by which the taxpayer loaned the money to the other organization was labeled a (erroneously in the view of the Tax Court) "swap".

The taxpayer contributed the "swap" to a unitrust in which each of his daughters had a 1% interest and the taxpayer had a remainder interest. Under the terms of the trust the taxpayer had the right to substitute property of equal value. He then sold his interest in the trust to two newly formed trusts, the sole beneficiary of each being one of his daughters. These trusts gave the taxpayer a note for $5.5 million.

Next up, the stock the taxpayer was going to sell was swapped into the unitrusts in exchange for the swap. The two trusts then acquired the daughter's unitrust interests. The unitrust would be terminated and the stock distributed to the two trusts. Next up, the stock would be contributed by the trusts to a partnership the taxpayer controlled, at which point the third party would purchase the stock from the partnership. The partnerships would distribute the cash to the trusts, which then would pay off the taxpayer's promissory notes. And, according to the promoters of the scheme, Mr. Bruce would walk away with $5.5 million cash (less, of course, the promoter's fees) tax-free.

This all depended, of course, on the manufacture of basis that could be attached to the stock via the "swap" transaction.

The Tax Court noted that, in reality, this was not a swap transaction such as that discussed in the case of *Bank One Corp. v. Commissioner*, 120 TC 174 (2003). Rather, the documents in question were effectively simply offsetting loans that had no real economic effect—and, in fact, the Court found no evidence that any cash actually ever changed hands on these notes and that they remained fully "paper" creations for their entire existence.

The Court notes that a true swap derives its value from an underlying asset, reference rate or index, something not true here, where all amounts to be advanced and repaid were fixed as of the date the transaction was entered into.

The Court found that the use of offsetting cash flows is a strong indication that a transaction lacked economic substance. The court also points out that "[t]he use of meaningless labels and the disregard of key terms (or the failure to act as a reasonable person would as to a violation or enforcement of the terms) also point to that end."

The Court found that the taxpayer triggered a gain when he sold his interest in the unitrust to the daughters' trusts for the promissory notes, which was not technically what the IRS was arguing for. The IRS argued that, effectively, all of these entities were acting on behalf of the taxpayer and so argued for taxation at the sale of the stock. While the Court agreed with that as a secondary view, the Court found that since the taxpayer had conceded (and the legal opinion he obtained also conceded) that the taxpayer would pay tax based on the gain or loss when the transfer of the unitrust interest took place.

Of course, the taxpayer had presumed he had a $5.5 million basis in that sold interest, something the Court did not agree to. But the Court noted that the attorney who wrote the opinion conveniently failed to mention what the basis of the unitrust interest would be for that sale. The Court reasoned that the attorney had intentionally avoided opining on the basis of the interest.

Thus, the Court found that the taxpayer had a fully taxable gain on sale. As well, the Court did not allow the taxpayer any deduction for the fees that he had paid for the transaction, finding that the fees did not relate to the business activity of the sold entity as the taxpayer argued.

Section: 4943
Foundation Fails to Show Reasonable Cause to Justifiy Abatement of First Tier Tax on Excess Holdings

Citation: TAM 201441021, 10/10/14

In TAM 201441021 the IRS was asked to look at the question of whether there was reasonable cause for a private operating foundation to have failed to realize that, due to a complex set of investments, the organization had stumbled into a situation where the combined holdings of the foundation and disqualified persons in certain companies exceeded the 20% threshold for excess business holdings under IRC §4943(c)(2)(A).

A foundation that has excess business holdings is subject first to an initial tax of 10% of the value of the holdings. If tax is imposed and the excess holdings are not disposed of by the close of taxable period, an additional 200% excise tax is due on the value of the holdings. The "taxable period" begins on the first day on which there are excess business holdings and ends on the earlier of the date a notice of deficiency with respect to the initial excise tax is mailed or the date the initial excise tax is assessed.

Under IRC §4962 the first-tier excise tax may be abated if the taxpayer shows the taxable event was due to reasonable cause and not due to willful neglect and that the event was corrected within the correction period for the event. The correction period is the 90 day period following the mailing of the notice of deficiency, a different time period than the period for avoiding the imposition of the second tier tax.

In this case the founder of the fund (a disqualified person, or DP) was the co-founder of an investment fund that was also a disqualified person. The investment firm created eight partnerships. The foundation invested in four of these partnerships. Disqualified persons invested in four other similar partnerships of the investment funds.

While the foundation and the DPs invested in different partnerships, the partnerships had a number of investments in common. The foundation failed to notice that this commonality of investment in the partnerships created situations that created excess holdings until the foundation had a new accounting firm prepare its Form 990-PF. The new accountants noticed the issue and pointed out that the foundation had excess holdings.

For the year in question the foundation prepared a Form 4720 that showed liability for the first tier tax. The foundation also filed a request for abatement of tax and in the request noted that it had uncovered two additional years of excess holdings. Initially the foundation did not submit a Form 4720 for those years, though eventually the Foundation prepared those forms and sent in a request for abatement of the first tier penalties for those years as well.

Due to restrictions imposed on the investment (they were private placement investments and thus difficult to dispose of), the foundation was not able to rapidly dispose of the interests in the partnerships. Eventually the partnership donated the shares of the funds to a public charity, being unable to sell off the investments to a buyer eligible to buy the interests.

The IRS, in ruling on the request for abatement, found that the taxpayer had to show three things in order to justify relief:

- The Foundation must have corrected the taxable event within the correct period;
- The taxable event was due to reasonable cause and not willful neglect; and
- The Foundation makes an affirmative showing of all facts necessary to justify reasonable cause relief

The Foundation cleared the first hurdle. The IRS noted that the Foundation disposed of the excess holdings within 90 days of the issuance of the notices of deficiency.

However the Foundation did not, in the view of the IRS, demonstrate that the second test was met. The Foundation had advanced two independent arguments that it claimed showed it met the second criteria.

First the Foundation argued that it had relied upon legal opinions when it made the investments that caused it to have excess holdings. The IRS noted that the Foundation claimed it had relied upon legal counsel in structuring the investment vehicles and was unaware that over time a situation could develop where the investments in the separate partnerships could create a problem.

However, the IRS noted that in order to show reliance on the advice of professionals a taxpayer generally must show:

- The adviser(s) in question were competent professionals who had sufficient expertise to justify reliance;
- The taxpayer provided necessary and accurate information to the adviser(s); and
- The taxpayer actually relied in good faith upon the advice of the adviser(s)

The IRS notes that the Foundation produced only a memorandum referencing advice regarding §4944 jeopardizing investments. The Foundation had not provided in support of its claim for relief any direct information on what information it provided to counsel for review on the excise tax issues, nor any evidence the counsel actually provided advice on the §§4943 or 4944 exposure of investments.

Failing to show that it either provided necessary information to the adviser, that advice was received from the adviser on the issue in question and, therefore, being unable to show it had relied upon such advice, the Foundation did not show reasonable cause due to reliance on erroneous advice of a professional.

The Foundation argued in the alternative that the tax should be abated because the Foundation was ignorant of the requirements of the law. The IRS, not unexpectedly, effectively held that "ignorance of the law is not an excuse."

However the IRS did go on to point out that the regulations under §4943 do provide factors that would demonstrate it was reasonable that a Foundation did not know, nor did it have reason to know, of an acquisition of business holdings by a disqualified person.

Those factors are:

- The Foundation had procedures reasonably calculated to discover such holdings that failed to uncover such holdings;
- There was sufficient diversity of such holdings by the Foundation; and
- There were a large number of disqualified persons who have little or no contact with the Foundation or its managers [Reg. §53.4943-2(v)]

The IRS found the Foundation failed to meet these tests. There were a small number of insiders who generally were deeply involved in the investments, there were insufficiently diversified holdings of the Foundation and the Foundation did not show the existence of any procedures designed to detect problematic acquisitions.

Therefore, the IRS held the Foundation failed to carry its responsibility to affirmatively demonstrate qualification for reasonable cause relief from the first tier penalty.

Section: 4962
Private Foundation Reasonably Relied on Erroneous Advice of Tax Preparer That it Did Not Have Excess Business Holdings, First Tier Tax Waived by IRS

Citation: TAM 201448032, 11/28/14

Whether a taxpayer had reasonable cause for a failure to discover its liability for the first tier tax on a private foundation for excess business holdings under §4943 pursuant to the provisions IRC §4962 was the key issue being examined in Technical Advice Memorandum 201448032.

The taxpayer in question was a private foundation. IRC §4943(a) imposes a 10% tax on the “excess business holdings” of a private foundation. Under IRC §4943(c)(2) permitted holdings is 20% of the voting stock of an incorporated business enterprise, reduced by shares held by any disqualified person.

The Foundation sought the advice of a tax adviser to comply with the tax laws. In this case it would turn out the adviser made an error in determining if there was an issue with regard to this tax.

As the TAM provides in its recitation of the facts:

> In Year, the tax preparer for Foundation analyzed the business holdings of Foundation and its disqualified persons and outlined them in a memorandum. The memorandum sought to determine if Foundation held excess business holdings for the prior tax year. The document concluded that the substantial contributors to Foundation and the family members thereof owned over seventeen percent of the stock of the corporation, but slightly miscalculated the total stock attributable to Foundation. The memorandum then misinterpreted the percentage allowable under §4943(c)(2) to conclude, incorrectly, that Foundation had no excess business holdings for the prior tax year. As the analysis concluded, albeit incorrectly, Foundation had no excess business holdings, the memorandum had no reason to discuss the five-year period to dispose of gifts, bequests, etc., allowed by §4943(c)(6). The internal memorandum ends with the note that the excess business holdings of Foundation should be evaluated annually.
>
> … When preparing the return for Foundation's Year tax year the tax preparer relied upon the analysis in the prior memorandum in order to determine that Foundation had no excess business holdings. Foundation did not change its holdings and did not report any excess business holdings on its Year return.

Thus the Foundation (and its adviser) went forward believing (erroneously it would be discovered) that there was no issue.

However when a new individual was assigned to deal with the filings for the Foundation, the problem was uncovered:

> When preparing the returns for Year1, Foundation's tax preparer assigned new individuals to the task. The new individuals performed a new analysis of Foundation's business holdings, discovered the earlier errors, and found that Foundation had excess business holdings in Year and Year1. Foundation filed the appropriate returns for Year1 and amended its returns for Year.

The Foundation then took appropriate actions to dispose of the excess interest and filed a Form 4720 for both years (the return on which the tax would be paid) asking for relief from the penalties for both years. Thus the issue came before the National Office.

The memorandum notes that, in order to have the penalty abated, the Foundation needed to demonstrate:

- The failure was due to reasonable cause;
- The failure was not due to willful neglect; and
- The taxpayer corrects the problem within the applicable correction period

The office noted that no one was contending that the Foundation had failed to pay the tax due because of willful neglect, nor that it had failed to correct the problem. But the memo notes "it is not enough to show that the mistake was merely not due to willful neglect, Foundation must also show that it was due to reasonable cause."

The memo first notes that the standard should be whether the Foundation acted with ordinary business care and prudence.

The Foundation had hired an outside expert to advise them in this area.

Of first importance was that the Foundation obtained that advice before a problem existed and provided all necessary information to the professional. As the TAM notes:

> In the year before Year Foundation's tax preparer drafted a memorandum stating that Foundation did not have excess business holdings. The prepared advice was not based on the five-year period for disposal provided for gifts under§ 4943(c)(6), which was still in effect. The written analysis by the tax preparer concluded that the amount of the holdings did not constitute excess business holdings and were thus permissible. This analysis gave no indication that Foundation's excess business holdings position would change without any change to the actual share holdings. Thus, Foundation had professional advice, before to the date it would need to reduce its excess business holdings, that it did not have excess business holdings due to not reaching, what it believed to be the applicable holdings. Based on the written advice of the tax preparer Foundation believed it had no need to reduce its business holdings. This tax advice was provided with full knowledge of the facts as demonstrated by email exchanges between Foundation and the preparer.
>
> In the first year in question, Foundation's tax preparer again relied on the analysis of the prior year's memorandum. Relying on this memorandum the tax preparer examined the nearly identical tax holdings of Foundation and came to the same erroneous conclusion, which the tax preparer provided to Foundation. When preparing Foundation's Year1 tax filings Foundation's tax preparer performed a new analysis with new individuals. It was at this time that the tax preparer informed Foundation it had excess business holdings for both Year and Year1.

Key here is both that the taxpayer sought the advice in time to have avoided the tax and, when informed of the error, took prompt action to correct the problem. Seeking outside advice from a qualified professional shows exercise of ordinary business care and prudence. Similarly, taking prompt action to correct the problem once it came to the Foundation's attention shows that it was relying upon that advice—that is, it presumably would have followed the advice, had it been received timely, to have divested itself of the excess holdings.

As the TAM notes:

> The written advice incorrectly concludes that Foundation should be below the 35 percent limit rather than the 20 percent limit. It should not be incumbent upon Foundation to validate the analysis of the professional tax preparer who has full information when it has received specific advice relating to the conclusions used in the preparation of its taxes. Foundation had specific communications with its tax preparer on this topic and knew that the preparer provided a specific analysis which cites both the

> law and the facts in the relevant case. There was no information in the written advice that put Foundation on notice as to the erroneous conclusion. Therefore, Foundation should be considered to have reasonable cause to continue with its status quo level of business holdings until it had been advised otherwise.

Therefore, the TAM concludes, the first tier tax will be waived.

Section: 4975
IRS Considering Increasing Information Reporting on Hard to Value Assets Held by IRAs

Citation: IRS Proposes Information Reporting Requirements for IRA Investments, CCH Federal Tax Day, November 14, 2013

CCH Federal Tax Day reported on November 14, 2013 that the IRS is proposing more detailed information reporting requirements for IRAs with "hard to value" investments. The report indicated that the IRS will make such reporting option for 2014. Presumably such reporting will not be optional in following years.

The IRS document cited in CCH's Advance Release section indicated that the following types of investments are being considered for additional reporting:

- Non-publicly traded stock,
- Partnership or LLC interests,
- Real estate, options

As well as other unspecified "hard to value" investments. The changes would affect reporting on Form 5498 and Form 1099-R. More information on these requirements will be in the 2014 instructions for those forms, expected to be issued near the end of 2013.

In 2013 the IRS had two significant wins in challenging rollover as business startup transactions (ROBS). See Ellis v. Commissioner, TC Memo 2013-245, 10/29/13 (related to taking salary from a corporation owned by the employee's IRA) and Peek v. Commissioner, 140 TC No. 12, 5/9/13 (where the beneficiary of the IRA guaranteed the debt of the corporation owned by the IRA). In both cases the IRS successfully attacked such structures under the prohibited transaction provisions of IRC §4975.

This reporting would make it much easier for the IRS to uncover such transactions. Presumably the additional information may also increase the cost of holding such transactions in IRA accounts even if there are not prohibited transaction issues.

Section: 4975
Payment of Salary by ROBS Formed Corporation to IRA Beneficiary Found to Be Prohibited Transaction

Citation: Ellis v. Commissioner, TC Memo 2013-245, 10/29/13

A ROBS (rollover as a business startup transaction) produced disastrous consequences for the individual whose rollover was involved in the case of Ellis v. Commissioner, TC Memo 2013-245, TC Memo 2013-245, http://www.ustaxcourt.gov/InOpHistoric/EllisMemo.Paris.TCM.WPD.pdf.

The issues in the case was whether the taxpayer had engaged in a prohibited transaction under IRC §4975 as part of his use of funds received from his previous employer's 401(k) plan to have his IRA start a used car business. If an IRA engages in a prohibited transaction, the entire balance of the account is deemed distributed to the IRA beneficiary and tax is triggered.

The IRS saw four separate point at which a prohibited transaction under §4975 had occurred:

- When Mr. Ellis had his IRA purchase an initial interest in the newly formed LLC (which elected to be taxed as a corporation) that previously had no ownership interests issued
- When Mr. Ellis received compensation from the entity as an officer of that entity after formation in 2005
- When Mr. Ellis received compensation from the entity as an officer in 2006 and
- When Mr. Ellis had the corporation enter into a lease with an entity owned by Mr. Ellis, his spouse and their children in 2006.

The Court found Mr. Ellis dodged the first bullet. The IRS argued that, as the corporation was constructively owned by Mr. Ellis, the original purchase of interests was a transaction with a disqualified person (the corporation controlled by Mr. Ellis). However, the Tax Court agreed with Mr. Ellis' reliance on its decision in the case of Swanson v. Commissioner, 106 TC 76, which held that a corporation with no shareholders was not a disqualified person. Only after the shares were issued (following the transaction) would the new entity become a disqualified person.

However, Mr. Ellis did not fare as well on the second issue. There, the Court Mr. Ellis controlled the corporation and the payments it would make to him. The court noted that:

> The direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan is a prohibited transaction under section 4975(c)(1)(D). Similarly, an act by a disqualified person who is a fiduciary whereby he directly or indirectly deals with the income or assets of a plan in his own interest or for his own account is a prohibited transaction under section 4975(c)(1)(E).

The Court found that the payment of salary to Mr. Ellis violated this provision. While it paid Mr. Ellis from its own bank account and not that of the IRA, the IRA had virtually exclusively funded the entity. The Court noted:

> To say that CST was merely a company in which Mr. Ellis' IRA invested is a complete mischaracterization when in reality CST and Mr. Ellis' IRA were substantially the same entity. In causing CST to pay him compensation, Mr. Ellis engaged in the transfer of plan income or assets for his own benefit in violation of section 4975(c)(1)(D). Furthermore, in authorizing and effecting this transfer, Mr. Ellis dealt with the income or assets of his IRA for his own interest or for his own account in violation of section 4975(c)(1)(E).

The Court also rejected the claim that §4975(d)(10) exempted the transaction. That provisions provides an exemption for reasonable compensation paid to a fiduciary for performance of duties of the plan. The Court found the payments were not for his duties of managing the investments of his IRA, but rather being the general manager of the car dealership.

The Court concluded:

> In essence, Mr. Ellis formulated a plan in which he would use his retirement savings as startup capital for a used car business. Mr. Ellis would operate this business and use it as his primary source of income by paying himself compensation for his role in its day-to-day operation. Mr. Ellis effected this plan by establishing the used car business as an investment of his IRA, attempting to preserve the

integrity of the IRA as a qualified retirement plan. However, this is precisely the kind of self-dealing that section 4975 was enacted to prevent.

That language does not bode well for other ROBS transactions, especially where the individual maintains any sort of connection to the entity and is compensated as part of that connection.

Section: 6011
TIGTA Reports on Growth of Tax Related Identity Theft and Problems With IRS Handling of Cases for Victims of Identity Theft and IRS CI Reports Updated Enforcement Statistics

Citation: TIGTA Report 2013-40-122, and TIGTA Report 2013-40-129, 11/7/13

Tax related identity theft is a growing problem, one that impacts the IRS, taxpayers and tax advisers who find a need to assist clients who have been the victims of identity theft. The Treasury Inspector General for Tax Administration issued two reports on the identity theft situation at the IRS in two reports:

- "Detection Has Improved; However, Identity Theft Continues to Result in Billions of Dollars in Potentially Fraudulent Tax Refunds", TIGTA Report 2013-40-122, http://www.treasury.gov/tigta/auditreports/2013reports/201340122fr.pdf
- "Case Processing Delays and Tax Account Errors Increased Hardship for Victims of Identity Theft", TIGTA Report 2013-40-129, http://www.treasury.gov/tigta/auditreports/2013reports/201340129fr.pdf

TIGTA provided the following overall illustrative description of tax related identity theft:

Figure 1: Description of Refund and Employment-Related Fraud

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of the identity theft process.

The first report outlines the growth of identity theft at the IRS. In many cases the theft is directed at obtaining fraudulent refunds. The report looks at IRS actions to prevent the issuance of such fraudulent refunds.

The scope of the problem, and a clue to its escalation, is found in the following table from the report:

Figure 1: Identity Theft Tax Returns Confirmed As Fraudulent in Processing Years 2011 and 2012

Processing Year	Number of Confirmed Identity Theft Tax Returns	Fraudulent Tax Refunds Prevented From Being Issued
2011	1,086,727	$ 7,972,883,955
2012	1,841,144	$ 12,108,211,555

Source: The IRS's Refund Fraud and Identity Theft Global Report for Calendar Year 2012.

But TIGTA's report went on to conclude that a significant number of potentially fraudulent returns escaped IRS detection—and that that the problem for 2011 may have affected another 1.1 million returns with potentially fraudulent refunds issued of $3.6 billion. The report does note that not all of those returns likely are truly fraudulent, as there could be innocent explanations for why the returns had the factors that the IRS has identified in fraudulent returns. But the report notes that the IRS, to be consistent, should have examined these returns more carefully.

The reported noted the IRS is getting better at identifying potentially fraudulent returns, as the dollar amount of potentially fraudulent refunds dropped by $1.6 billion from the prior year.

However, to this author the numbers would suggest that the IRS has concentrated on identifying larger potential refunds (the average refund in the confirmed cases is over twice the average refund in the questionable cases). Unfortunately, if this is the case it means sophisticated ID theft operations may determine the effective "cut-off" level and simply insure their individual claims come in below that level.

The IRS response to this matter is to attempt to expand the number of potentially fraudulent returns and increase the use of locks on such returns. While without question increasing the chance fraudulent refunds will be caught before being issued, such actions are not without potential impact on innocent taxpayers. Such a system will, by its very nature, flag some returns as "potentially fraudulent" where a return is, in fact, legitimate.

Unfortunately, as the second report suggests, the IRS does not necessary move quickly to deal with identity theft cases. The second report notes that the IRS informed employees working the cases to tell taxpayers their case would take 180 days to process—but the report found no evidence to support that time frame for expected clearance and, in fact, found the average case took much longer to process.

The number of taxpayers impacted either by having their return flagged as potentially involved with identity theft or themselves reporting to the IRS that they may be a victim of identity theft is summarized below:

Figure 2: Identity Theft Incidents and Taxpayers Affected During CY 2010 Through CY 2013

Calendar Year	IRS-Identified		Taxpayer-Initiated		Total	
	Incidents	Taxpayers	Incidents	Taxpayers	Incidents	Taxpayers
2010	338,753	201,376	101,828	69,142	440,581	270,518
2011	1,014,884	553,730	110,750	87,322	1,125,634	641,052
2012	1,508,375	985,843	277,491	233,365	1,785,866	1,219,208
2013*	1,688,817	1,449,602	212,288	181,009	1,901,105	1,630,611

Source: *IRS Identity Protection Incident Tracking Statistics Reports.*[4]
* CY 2013 figures are through June 29, 2013.

The report only considered closed cases in evaluating IRS processing, and noted that various IRS actions to improve the process may result for shorter processing times and fewer issues for cases still in process. But in looking at closed cases it's pretty clear taxpayers who end up in an identity theft situation are looking at having a long ordeal to survive with the IRS.

TIGTA reported the following average time periods to resolve cases:

Figure 4: Days Taken to Resolve Identity Theft Cases

Number of Cases	Percent	Range of Days to Resolve Cases
15	15%	Less Than 151
9	9%	151 to 200
17	17%	201 to 250
18	18%	251 to 300
17	17%	301 to 365
9	9%	366 to 400
4	4%	401 to 500
11	11%	Greater Than 500

Source: *TIGTA analysis of days to resolve cases in our sample.*

The report also found that quite often cases could go long periods with no activity by the IRS due to various factors, including frequent reassignments of cases to different employees. The periods of inactivity for the cases TIGTA looked at are summarized in the table below:

Figure 5: Analysis of Inactivity on Identity Theft Cases

Number of Cases	Percent	Range of Days Cases Were Inactive
19	19%	Less Than 151
16	16%	151 to 200
19	19%	201 to 250
14	14%	251 to 300
16	16%	301 to 365
3	3%	366 to 400
4	4%	401 to 500
9	9%	Greater Than 500

Source: TIGTA analysis of the number of days cases were inactive.

These days it is the rare adviser who has not had a client that has managed to run into a tax related identity theft issue. The TIGTA reports can help provide some information about the true time period that the taxpayer is likely to be in limbo (including having legitimate refunds tied up and being unable to get tax information verified to mortgage lenders) as well as reminding advisers that the problem is continue to grow as it still remains a profitable, if wildly illegal, activity for those engaging in identity theft.

Just following the 2014 tax season, the IRS released statistics (IR-2014-50, http://www.irs.gov/pub/irs-news/IR-14-050.pdf) on the current status of criminal investigations into identity theft by IRS Criminal Investigation. From the beginning of 2014 through April 10, the CI had the following statistics on identity theft issues:

Initiations	Prosecution Recommendations	Completions	Indictments	Sentencing Hearings	Average Months Served	Total ID Theft Investigations
295	272	316	221	189	48	1898

For perspective, they also gave statistics on prior fiscal years:

	FY 2013	FY 2012	FY 2011
Investigations Initiated	1492	898	276
Prosecution Recommendations	1257	544	218
Indictments/Informations	1050	494	165
Sentenced	438	223	80

Section: 6011
Failure to Attach Withholding Forms Rendered Return Not Processible, Interest on Overpayment Did Not Begin to Run Until Information Submitted

Citation: Duetsche Bank AG v. United States, 106 AFTR2d 2010-6992 (95 Fed. Cl. 423), affd. CA FC, 113 AFTR 2d 2014 509, 2/18/14

In the case of *Duetsche Bank AG v. United States*, 106 AFTR2d 2010-6992 (95 Fed. Cl. 423), *affd*. CA FC, 113 AFTR 2d 2014-509, a corporation's failure to submit withholding forms with the tax return was found to render the return not in processible form, thus the IRS did not have to begin to pay interest until the return was received in what it viewed as a processible form.

Under IRC §6011(e)(1) the IRS is required to pay interest on overpayments reported on a tax return if the refund is not paid within 45 days of the later of the due date (without extensions) of the return or the date the return is actually filed. However a return will not be deemed filed unless it is filed in "processible" form as defined by IRC §6011(g)(1). To be processible a return must

- Be filed on a permitted form and
- The return contains
  - The taxpayer's name, address, identifying number and signature *and*
  - Sufficient required information to permit the mathematical verification of the tax liability shown on the return [IRC §6011(g)(2)]

The corporation argued that there was nothing in the Code or Regulations that required attaching these forms (Form 1042-S and Form 8805) to the corporation's Form 1120-F. However, the Court held that the forms themselves clearly required that they be attached to the return, and that IRC §6011(a) specifically requires filing the return in accordance with the forms and instructions issued by the IRS.

The corporation also argued that the return as submitted should be seen as containing sufficient information to be processed. The corporation, when it sent in the information after the IRS sent it back the return asking for the initial information, noted that it had made an error in adding up the withholding and asked the IRS to adjust that amount—that is, the forms showed the withholding did not total to what was shown on the return. The corporation included a letter noting the problem and, while it did not file an amended return, asked the IRS to correct the filing. The IRS did not do so, and rather paid the refund shown on the return. The taxpayer argued that since the IRS did not actually consult that missing information when it did process the return, the information clearly was not needed to process the return.

The Court disagreed, noting that the very fact those forms would have allowed the IRS to unearth an error shows that they were of import, and the failure to attach them was significant. As well, the later failure of the IRS to correct the return did not invalidate the deficiency of the submitted return.

On appeal the Federal Circuit agreed with the IRS's position, sustaining the original ruling of the Court of Federal Claims.

One additional area of concern raised by the decision is the reliance in both the original decision and the decision of the appellate panel in part on IRC §6011(a) requirement that a taxpayer must make a return or statement according to the "forms and regulations" prescribed by the Secretary. The courts found that a filing requires not only using the forms but also following the instructions related to the various forms.

As the Federal Circuit panel noted:

> As a general matter, IRS had the authority to require Deutsche Bank to attach Forms 8805 and 1042-S to its 1999 tax return. Section 6011 of the Code provides that a taxpayer "shall make a return or statement according to the forms and regulations prescribed by the Secretary [and] shall include therein the information required by such forms or regulations." 26 U.S.C. § 6011(a) (2000). The requirement to include Forms 8805 and 1042-S in Deutsche Bank's 1999 tax return appears not only on the face of those forms and the form instructions but also on the principal tax return form, Form 1120F, and its instructions. … Deutsche Bank's original return failed to satisfy that requirement.
>
> The Claims Court did not err in relying on the general compliance rule of section 6011(a) and IRS form instructions to determine whether Forms 8805 and 1042-S were "required attachments" under section 6611(g)(2)(B)(ii). Congress enacted sections 6611(b)(3) and 6611(g) to restrict payment of

interest for certain time periods, such that interest on an overpayment does not accrue until the return reporting the overpayment is filed in processible form.

The obvious question arises about whether the Courts would take a similar view of the wide reach of "following the instructions" where other definitions of "filing" are involved, such as a filing of a return to begin the statute of limitations for an assessment of tax. Certainly it suggests, as does *AICPA Statement of Standards for Tax Services No. 2* when giving guidance with regard to answering questions on a return, whether a failure to follow instructions might cause a return to be deemed to be not filed, resulting in harm to the taxpayer. Certainly it appears, at a minimum, such a failure could cost the taxpayer a right to a payment of interest on a delayed refund.

Section: 6011
ERO Requirements in Specific Situations Outlined in Memo

Citation: CCA 201407013, 2/14/14

The Chief Counsel's office issued a ruling outlining rules applicable to electronic return originators (EROs) in Chief Counsel Advice 201407013 (http://www.irs.gov/irs-wd/1407013.pdf).

Specifically, the ruling comes to the following conclusions:

1. It is a violation of IRS e-file rules for an ERO to share its Electronic Filing EFIN with others.

2. It is not a violation of IRS e-file rules for an employee of an ERO to prepare returns at a location other than the business location provided on the ERO's Form 8633.

3. It is a violation of IRS e-file rules for an ERO to electronically originate returns prepared by a subcontractor, regardless of where the returns are prepared.

4. An ERO that is also a return preparer must exercise due diligence in accordance with the provisions of the Code, Treasury Regulations, and Publication 1345, Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns.

5. It is a violation of IRS e-file rules for an ERO to electronically originate returns that it did not prepare or collect from a taxpayer. IRS e-file rules do not address whether an ERO must exercise due diligence in reviewing returns that are prepared by, or collected from, a subcontractor of the ERO. An ERO becomes an income tax return preparer of the returns, and is subject to return preparer due diligence requirements, when, as a result of entering data from a return prepared by a subcontractor, it discovers errors that require substantive changes and then corrects the errors before filing the return.

6. Electronically filing an income tax return with a borrowed EFIN does not alone invalidate a return. If the tax return otherwise meets the established criteria for a valid return, it should be processed, despite being filed with a borrowed EFIN.

7. Whether return preparer penalties may be imposed against an ERO depends on whether the ERO is a tax return preparer. Return preparer penalties may be imposed against an ERO that meets the definition of a tax return preparer under Internal Revenue Code (Code) § 7701(a)(36) and Treasury Regulation § 301.7701-15.

The third ruling may cause some concerns initially. While the ruling is not absolutely clear, it appears that the ruling is contemplating the issue where an ERO attempts to avoid being a "preparer" by having a non-employee contractor prepare the return. Presumably no employee of the ERO would be the signing preparer of the return.

The IRS specifically cites the following guidance found in Publication 3112:

> According to Publication 3112, "[a]n ERO must originate the electronic submission of only returns that the ERO either prepared or collected from a taxpayer."

While that is “only” from a publication, Revenue Procedure 2007-40 specifically requires all Authorized e-file Providers to comply with all provisions of publications covering e-file.

The regulations under §7216 governing clearly contemplate the use of non-employee assistants in the preparation of returns and, in fact, allowing the use of outside assistants is the only disclosure issue where a preparer can decline to prepare the return if the client will grant the right to disclose. It would seem somewhat odd for the IRS to now conclude that such a return could not be electronically filed, especially since in virtually all cases electronic filing would be required.

Thus it seems that the real issue (though not stated as such) is a requirement that the signing preparer be an employee of the ERO.

The overall tone of the memo seemed to dealing with cases where EROs were “sharing” their EFIN with other parties who (for whatever reason) did not have an EFIN. As should be expected, that is not allowed.

Section: 6015
IRS No Longer to Enforce Two-Year Deadline for Applying for Equitable Innocent Spouse Relief, New Revenue Procedure and Proposed Regulations Issued to Implement New Policy

Citation: Revenue Procedure 2013-34, 9/16/13 REG-132251-11, 8/13/13, Notice 2012-8, 1/5/12 and Notice 2011-70, 7/25/11

Despite a number of victories at the Court of Appeals level, the IRS reversed course and announced that the agency will no longer automatically deny a request for innocent spouse relief under the equitable relief provisions of §6015(f) that is requested more than two years after the first collection activity. The change of position was announced in Notice 2011-70 (http://www.irs.gov/pub/irs-drop/n-11-70.pdf).

The Notice outlined various relief to be granted in cases where the request was made prior to the July 25, 2011 effective date of the notice. As well, the IRS later released Notice 2012-8 that described a proposed Revenue Procedure that revised innocent spouse applications in line with the new IRS position. (http://www.irs.gov/pub/irs-drop/n-12-08.pdf)

In Notice 2011-70, the IRS announced plans to revise the regulations under §6015 to remove the two year deadline. The IRS has now issued the proposed regulations to implement this provision (http://www.gpo.gov/fdsys/pkg/FR-2013-08-13/html/2013-19502.htm).

The proposed regulations in Proposed Reg. §1.6015-1(b) remove the 2 year deadline for applications for equitable relief under §6015(f). Rather, the application must be filed within the statute of limitations on collection of tax under IRC §6502 or the period for credits and refunds under IRC §6511. As was true under the prior regulations, the IRS will not consider an application for relief filed prior to the receipt of either a notice of examination from the IRS or a notice indicating that there exists an unpaid tax liability for a year.

The proposed regulations add a similar rule for the provision of equitable relief to taxpayers in community property states looking for equitable relief under IRC §66(c).

The preamble to the proposed regulations provide the following regarding co-ordination with the provisions announced in Notice 2011-70:

> Notice 2011-70 announced that the Treasury Department and the IRS intended to amend the regulations under section 6015 to remove the requirement that taxpayers request equitable relief under section 6015(f) and Sec. 1.6015-4 within two years of the first collection activity. Under section 7805(b)(1)(C), the proposed regulations provide that Sec. 1.6015-5(b)(1) and (b)(2) will be effective as of July 25, 2011, the date that Notice 2011-70 was issued to the public.

Fulfilling previously announced intentions per Notice 2011-70 and Notice 2012-8 described above, the IRS released Revenue Procedure 2013-34, http://www.irs.gov/pub/irs-drop/rp-13-34.pdf, which provides revised procedures for individuals seeking relief from joint and several liability under the provisions of IRC §6015(f) and from the impact of community property laws on a separate return pursuant to IRC §66(c).

In Notice 2012-8 this ruling had been issued as a proposed revenue procedure, asking for comments on the procedure. The Revenue Procedure indicates that the final version took into consideration certain substantive comments received regarding the proposed revenue procedure.

The IRS highlights the following changes from Revenue Procedure 2003-61, which is superseded by the new Revenue Procedure:

- Greater deference is given to the presence of abuse;
- Relief can now be requested before the expiration of the period of limitation for collection under section 6502 to the extent the taxpayer seeks relief from an outstanding liability, or before the expiration of the period of limitation for credit or refund under section 6511 to the extent the taxpayer seeks a refund of taxes paid;
- Relief would not be precluded for an item attributable to the requesting spouse if the nonrequesting spouse's fraud gave rise to the understatement of tax or deficiency even if the underlying income is that of the requesting spouse, as outlined in the example provided in the Revenue Procedure;

> **Example:** W fraudulently accesses H's brokerage account to sell stock that H had separately received from an inheritance. W deposits the funds from the sale in a separate bank account to which H does not have access. H and W file a joint Federal income tax return for the year, which does not report the income from the sale of the stock. The Service determines a deficiency based on the omission of the income from the sale of the stock. H requests relief from the deficiency under section 6015(f). The income from the sale of the stock normally would be attributable to H. Because W committed fraud with respect to H, however, and because this fraud was the reason for the erroneous item, the liability is properly attributable to W.

- The new procedure provides that no one factor or a majority of factors will control the determination of qualification for relief;
- Minimum standards are established for economic hardship based on income, expenses and assets, but a lack of finding of economic hardship is no longer a factor that weighs against relief. These standards are described as noted below in the Revenue Procedure:

> In determining whether the requesting spouse would suffer economic hardship if relief is not granted, the Service will compare the requesting spouse's income to the Federal poverty guidelines (as updated periodically in the Federal Register by the U.S. Department of Health and Human Services under the authority of 42 U.S.C. § 9902(2)) for the requesting spouse's

family size and will determine by how much, if at all, the requesting spouse's monthly income exceeds the spouse's reasonable basic monthly living expenses.

This factor will weigh in favor of relief if the requesting spouse's income is below 250% of the Federal poverty guidelines, unless the requesting spouse has assets out of which the requesting spouse can make payments towards the tax liability and still adequately meet the requesting spouse's reasonable basic living expenses.

If the requesting spouse's income exceeds 250% of the Federal poverty guidelines, this factor will still weigh in favor of relief if the requesting spouse's monthly income exceeds the requesting spouse's reasonable basic monthly living expenses by $300 or less, unless the requesting spouse has assets out of which the requesting spouse can make payments towards the tax liability and still adequately meet the requesting spouse's reasonable basic living expenses.

If the requesting spouse's income exceeds 250% of the Federal poverty guidelines and monthly income exceeds monthly expenses by more than $300, or if the requesting spouse qualifies under either standard but has sufficient assets to make payments towards the tax liability and still adequately meet the requesting spouse's reasonable basic living expenses, the Service will consider all facts and circumstances (including the size of the requesting spouse's household) in determining whether the requesting spouse would suffer economic hardship if relief is not granted.

- Actual knowledge of the item giving rise to the understatement or deficiency will no longer be weighed more heavily than other factors. If the nonrequesting spouse either abused the requesting spouse or restricted that spouse's access to financial information, rendering that spouse unable to challenge the treatment due to fear of retaliation, this factor will be a factor weighing in favor of relief even if the requesting spouse knew or had reason to know of the item(s) in question;
- In determining if the requesting spouse knew or had reason to know the tax would not be paid, the procedure considers if the requesting spouse reasonably expected that the nonrequesting spouse would pay the tax at the time the return was filed or shortly thereafter. The final version of the Revenue Procedure adds a presumption of such a reasonable expectation if a request for an installment agreement was filed within 90 days of the later of the due date of the payment of tax or the date the return was filed. As well, a finding of abuse or maintenance of control of the finances by the nonrequesting souse will be a factor weighing in favor of relief even if the requesting spouse knew or had reason to know the tax would not be paid;
- The legal obligation factor is clarified to state that not just whether the nonrequesting spouse had a legal obligation to pay the liabilities, but also whether the requesting spouse had such a legal obligation to pay;
- The significant benefit factor will not weigh against relief if:
  - The nonrequesting spouse abused the requesting spouse or maintained financial control and made the decisions regarding living a more lavish lifestyle (will weigh in favor of relief);
  - Only the nonrequesting spouse significantly benefitted from the unpaid tax or understatement, and the requesting spouse had little or no benefit, or the nonrequesting spouse enjoyed the benefit to the requesting spouse's detriment (will weigh in favor of relief); or

    - The amount of unpaid tax or understatement of tax was small such that neither spouse received a significant benefit (In such a case this factor is neutral). The final Revenue Procedure added a provision that the determination that the tax liability was small such that neither spouse received a significant benefit will vary depending on the facts and circumstances of each case.
- The requesting spouse's subsequent compliance with Federal income tax laws is treated as a factor in favor of granting relief, rather than a neutral factor; and
- The rule that limited refunds in cases involving deficiencies to payments made by the requesting spouse pursuant to an installment agreement is removed in the new Revenue Procedure

The new procedure is effective for requests for relief filed on or after September 16, 2013, as well as requests pending as of that date, whether with IRS, in Appeals or in a case docketed with a Federal court.

Section: 6103
Revenue Agent's Report and Unagreed Case File Can Be Provided to Office of Professional Responsibility for Use in Disciplinary Investigation

Citation: CCA 201403006, 1/17/14

In CCA 201403006 (http://www.irs.gov/pub/irs-wd/1403006.pdf) the IRS Chief Counsel's Office concluded that a practitioners' Revenue Agent Report (RAR) and an unagreed case file from an examination of that individual's own return may be made available to the Office of Professional Responsibility for their use in investigating the conduct of the practitioner.

Or to say it differently, the practitioner cannot delay the receipt of that information by the OPR by taking his/her tax case to Appeals.

The Advice concludes that the IRS has the authority under IRC §6103 to provide the information to employees of OPR, as they are IRS employees using the information in the administration of the tax law. Therefore, no special treatment applies that would deny the transfer of such information merely because the practitioner is still actively contesting the case at exam or on appeal.

The memorandum notes that the OPR makes its own independent determination of the taxpayers compliance with the rules found in Circular 230, and that the decision of Appeals does not impact that determination.

Section: 6103
SB/SE Fast Track Settlement Program Becomes Nationwide Program

Citation: IRS News Release IR-2013-88, 11/6/13

The IRS announced the expansion of the Fast Track Settlement Program, making it available to all small taxpayers, in news release IR-2013-88. [http://www.irs.gov/pub/irs-news/IR-13-088.pdf]

Details of the Fast Track Settlement Program can be found in Announcement 2011-5, which described the prior pilot program. [http://www.irs.gov/irb/2011-04_IRB/ar10.html] The notice provides that the program is generally available, subject to limitations, to cases under the jurisdiction of the SB/SE Division that meet the following criteria:

- Issues are fully developed;
- The taxpayer has stated a position in writing (or filed a small case request for cases in which the total amount for any tax period is less than $25,000); and
- There are a limited number of unagreed issues.

Specifically excluded from qualification are the following types of cases mentioned in Announcement 2011-5:

- Collection Appeals Program, Collection Due Process, Offer-In-Compromise and Trust Fund Recovery cases, except as provided in any guidance issued by the Service;
- Correspondence examination cases worked solely in a Campus/Service Center site;
- Cases in which the taxpayer has failed to respond to Service communications and no documentation has been previously submitted for consideration by Compliance;
- Tax Equity & Fiscal Responsibility Act (TEFRA) partnership cases;
- Issues outside SB/SE jurisdiction, except as provided below;
- Issues designated for litigation;
- Issues under consideration for designation for litigation;
- Issues for which the taxpayer has submitted a request for competent authority assistance;
- Issues for which the taxpayer has requested the simultaneous Appeal/Competent Authority procedure described in section 8 of Rev. Proc. 2002-52, 2002-2 C.B. 242, or the corresponding provision of any successor guidance;
- Frivolous issues, such as, but not limited to, those identified in Rev. Proc. 2006-2, 2006-1 C.B. 89, or any successor guidance;
- "Whipsaw" issues, i.e., issues for which resolution with respect to one party might result in inconsistent treatment in the absence of the participation of another party; or
- Issues that have been identified in a Chief Counsel Notice, or equivalent publication, as excluded from the SB/SE FTS process.

Taxpayers are not required to use the Fast Track program, but must apply to request participation in the program. The IRS has the option as well to decide to accept or not accept Fast Track program participation, as well as to initiate the request for the Fast Track program. Generally a request to participate needs to be made before the 30-day letter is issued.

If the Fast Track Settlement Program is used, an Appeals representative generally will be appointed to serve as a mediator to attempt to settle the issues in question. The taxpayer will retain full appeals rights if the matter cannot be settled.

The goal of the program is to settle cases that enter the program within 60 days.

Section: 6019
Revising Previously Announced Policy, IRS to Expire Only ITINs Not Used to File Return for Five Consecutive Years

Citation: News Release IR-2014-76, 6/30/14

In News Release IR-2014-76, http://www.irs.gov/uac/Newsroom/Unused-ITINS-to-Expire-After-Five-Years;-New-Uniform-Policy-Eases-Burden-on-Taxpayers,-Protects-ITIN-Integrity, the IRS announced revisions to its policy to begin expiring ITINs.

The IRS noted that only ¼ of the 21 million ITINs issued since 1996 are being used on tax returns, so the IRS had announced a program that would automatically expire ITINs after 5 years. Thus, any person that received an ITIN would be required to reapply for an ITIN every five years even if a return was filed for each year in the interim.

The IRS has now modified the program so that ITINs will only be expired if they have not been used for five consecutive tax years. These taxpayers will need to reapply.

The IRS will not actually expire an ITIN until 2016, so any previously issued ITINs can be used during the upcoming filing season.

Section: 6159
IRS Proposes to Raise Fees for Installment Agreements and Offers in Compromise on January 1, 2014

Citation: REG-144990-12, 8/30/13

The IRS, in REG-144990-12, https://s3.amazonaws.com/public-inspection.federalregister.gov/2013-21243.pdf, has proposed to increase user fees for offers in compromise and installment agreements, effective January 1, 2014.

The basic user fee for installment agreements without a direct debit agreement would rise to $120 from $105, while the fee for restructuring or reinstating an agreement would increase to $50 from $45. Fees for agreements where the taxpayer agrees to a direct debit arrangement would remain unchanged at $52. Similarly, there would be no increase in the $43 fee for low income taxpayers.

The fee for an offer in compromise will rise to $186 from $150. The waiver of the fee for low income taxpayers and taxpayers applying based on a doubt as to liability will continue to exist.

Section: 6201
Taxpayer's Production of "Self-Serving" Testimony Not Sufficient to Shift Burden to IRS Under §6201(d)

Citation: Berks v. Commissioner, T.C. Summary Opinion 2014-2, 1/6/14

In the case of Berks v. Commissioner, T.C. Summary Opinion 2014-2, http://www.ustaxcourt.gov/InOpHistoric/BerksSum.Guy.SUM.WPD.pdf, a taxpayer who failed to take actions to monitor various investments in his IRA that his adviser asserted had become worthless ended up with a tax liability on the distribution shown on the Form 1099R.

The taxpayer in the case had taken money from rather boring IRA investments and instead put them into various promissory notes held in a self-directed IRA that their financial adviser suggested. The adviser, who served as the general partner of the partnerships issuing the promissory notes, also found the trustee who would agree to hold the notes.

The notes paid a high interest rate, but that rate would be paid only if the properties were developed or sold. The taxpayer did not look very closely at these activities, nor do any monitoring of them.

The financial adviser counseled the IRA custodian to value the interests at book value for tax purposes. He claimed that between 2001 and 2006 all of the various notes became worthless, the partnership having failed for various reasons. However, the adviser produced no books, records or other documents to substantiate his testimony.

When the notes matured, the custodian inquired about whether the notes would be renewed. The taxpayer turned over all inquiries in this area to the adviser who told the custodian the notes were worthless but provided no other details. Eventually the trustee resigned and issued Forms 1099R continuing to value the notes at book value.

The taxpayer's CPA reported the distributions on the taxpayer's return, but showed none of it as taxable. The IRS, following the Form 1099R, asserted the taxpayer had taxable income.

The Tax Court agreed with the IRS in this case. While noting that under IRC §6201(d) requires the IRS to look beyond the Form 1099R when the taxpayer asserts a reasonable dispute and has fully cooperated with the IRS, the court found that the taxpayers produced no objective evidence in support of their position.

The Court found the adviser not to be a credible witness. The Court found it difficult to believe that the adviser had no records of any sort to back up the failures of partnerships in which he was the general partner. The Court also found that the taxpayer's failure to take even the most basic steps to corroborate what he was told by the financial adviser similarly brought into question the supposed "evidence" of the investments being worthless.

While IRC §6201(d) is an important tool to be used when the IRS is attempting to collect tax based solely on an information return, this case reminds us that the taxpayer needs to act in a way that indicates he/she has produced evidence on the issue that he/she should have—something that did not happen in this case.

On the same day, the Tax Court decided another case with essentially the same fact pattern with the same adviser (see *Gist v. Commissioner*, T.C. Summary Opinion 2014-1, http://www.ustaxcourt.gov/InOpHistoric/GistSum.Guy.SUM.WPD.pdf).

Section: 6201
Restitution Payments Ordered As Part of Criminal Tax Case May Be Applied By IRS to Liabilities for Years Other Than Those Used to Compute the Amount of Restitution

Citation: CCA 201341034, 10/25/13

Even though payments were made as restitution payments for underpayments related to specific years by a taxpayer as part of a criminal case resolution, the IRS held it is not required to apply those payments to the particular years involved. Rather, the IRS may apply the payment to any outstanding tax liability of the individual. [Chief Counsel Advice 201341034, http://www.irs.gov/pub/irs-wd/1341034.pdf]

In the case in question the individual was convicted on two counts under a criminal prosecution for two years. The individual, as part of his sentence, was ordered to pay restitution to the IRS related to those two years.

However, the taxpayer had other outstanding liabilities, and it was in the best interests of the IRS if those payments were to be applied to items other than the specific items that were used in computing the restitution. The CCA held that because this was an involuntary payment and the court order did not specify how payments should be allocated, the IRS was free to apply the funds as it saw fit.

Section: 6201
IRS Fails to Meet Its Burden Under §6201(d) to Show Validity of 1099R Information Once Taxpayer Raised Reasonable Doubts About Its Veracity

Citation: Furnish v. Commissioner, TC Summary Opinion 2013-18, 10/23/13

For tax practitioners who deal with IRS challenges to a taxpayer's return based on third party information returns, IRC §6201(d) is a crucially important section to understand. The taxpayer in the case of Furnish v. Commissioner, TC Summary Opinion 2013-18, http://www.ustaxcourt.gov/InOpHistoric/FurnishSummaryGuy.SUM.WPD.pdf was able to prevent the IRS from collecting tax from him based on a Form 1099R which he disputed.

The question involved one that often arises for clients who have attempt to use "vanishing premium payments" on cash value life insurance—the policy premiums are paid from the cash value and earnings on the policy. Those are sufficient to keep the policy in force for a long time, but not sufficient to keep the policy alive longer than the insured. When the funds run out to pay the premiums, the cash value is used to pay off the policy loan, triggering the potential for taxable income when the cash value ends up being well in excess of the taxpayer's basis in the policy.

In this case, Mr. Furnish was an actuary—a specialty that tends to lead to more than a passing familiarity with the quirks and complexities of a life insurance contract. He received a Form 1099R indicating that policies he had acquired long ago and ceased paying premiums on years before had lapsed and that he had taxable income on the excess of the cash value over the premium.

Mr. Furnish lacked confidence that the insurance company had properly computed the relevant items, bringing into question (at least to him) whether the policy had actually lapsed in the year in question as well as the computation of the purported gains. The insurance company responded to his concerns by producing some information, but did not give him detailed information back to the date he took out the policy, as it wasn't in their electronic systems, and they refused to go look up the "pre-electronic" records.

Mr. Furnish did point out some inconsistencies in the computations that were provided.

IRC §6201(d) provides:

> In any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return filed with the Secretary...by a third party and the taxpayer has fully cooperated with the Secretary (including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer as reasonably requested by the Secretary), the Secretary shall have the burden of producing reasonable and probative information concerning such deficiency in addition to such information return.

Mr. Furnish claimed he raised just such a reasonable dispute.

The IRS countered that Mr. Furnish had only shown relatively minor potential issues with the carrier's computations. The court agreed, but noted that the number of such issues and the fact that even minor differences such as these, had they occurred frequently enough and at the proper times during the "pre-electronic" period for which no records were produced could very well show that the lapse had not occurred in 2009, the year in which the IRS sought to collect tax.

The IRS also complained that the taxpayer had only raised the issue just before the trial. The Court rejected that complaint, noting the taxpayer had corresponded in detail with the IRS at various times in the process, pointing out his concerns and the issues he saw.

The IRS also argued that they had made inquiries of the carrier, and the records provided supported the 1099R issued. The Court pointed out that the provided material was simply a duplicate of the information provided to Mr. Furnish, information that was effectively limited to asserting "we computed this correctly" without providing evidence that the computation was actually correct.

Thus, the IRS had failed to meet its burden of proof—a burden placed on the IRS by IRC §6201(d).

Practitioners must remember that, despite what the IRS computer spewing forth CP2000s says, a Form 1099, W-2, etc. does not represent absolute proof of either the existence of an item of income or its amount. Rather, a taxpayer has a right to challenge that form. To do so the taxpayer must provide all records he/she has with regard to the item of income and cooperate fully with the IRS.

Normally the taxpayer should also attempt to get information on how the information form was computed by the issuer since, as was true here, doing so goes a long way to show that reasonable doubt has been raised. Once the carrier had to show that, so to speak, the 1099R emperor had no clothes, the Court was very sympathetic to the taxpayer.

Section: 6212
New Form Required to Report Change of Business Address or Responsible Party Effective January 1, 2014

Citation: Form 8822-B, 8/23/13

The IRS has released new Form 8822-B, Change of Address or Responsible Party (http://www.irs.gov/pub/irs-pdf/f8822b.pdf) that must be used to notify the IRS of a business's change of address or a change in the "responsible party" that has been identified for that organization.

Form **8822-B** (Rev. August 2013) Department of the Treasury Internal Revenue Service

Change of Address or Responsible Party — Business

► Please type or print.
► See instructions on back. ► Do not attach this form to your return.
► Information about Form 8822-B is available at *www.irs.gov/form8822*.

OMB No. 1545-1163

Before you begin: If you are also changing your home address, use Form 8822 to report that change.

If you are a tax-exempt organization (see instructions), check here ☐

Check **all** boxes this change affects:

1 ☐ Employment, excise, income, and other business returns (Forms 720, 940, 941, 990, 1041, 1065, 1120, etc.)

2 ☐ Employee plan returns (Forms 5500, 5500-EZ, etc.)

3 ☐ Business location

4a Business name | **4b** Employer identification number

5 **Old mailing address** (no., street, room or suite no., city or town, state, and ZIP code). If a P.O. box, see instructions. If foreign address, also complete spaces below, see instructions.

Foreign country name | Foreign province/county | Foreign postal code

6 **New mailing address** (no., street, room or suite no., city or town, state, and ZIP code). If a P.O. box, see instructions. If foreign address, also complete spaces below, see instructions.

Foreign country name | Foreign province/county | Foreign postal code

7 **New business location, if different from mailing address** (no., street, room or suite no., city or town, state, and ZIP code). If a foreign address also complete spaces below, see instructions.

Foreign country name | Foreign province/county | Foreign postal code

8a Old name of responsible party | **8b** New name of responsible party

9a Old SSN, ITIN, or EIN of responsible party | **9b** New SSN, ITIN, or EIN of responsible party

10 **Signature**

Daytime telephone number of person to contact (optional) ►

Sign Here ► Signature of owner, officer, or representative | Date

► Title

The instructions to the form indicate that it must be used, effective January 1, 2014, to notify the IRS of such changes.

As the boxes at the top indicate, this form covers payroll tax, excise tax, income tax, employee benefit plan returns and the business location. The instructions indicate notice must be given within 60 of the change.

Notices of deficiency and other documents only must be mailed to the "last known address" to be validly issued, and whether or not the taxpayer actually receives them does not mean that the time limitations do not run for the taxpayer to file Tax Court petitions or take other protective actions. That's true even if the document is returned to the IRS as rejected because the party is no longer at that address.

Thus, business clients must be warned to file this form. If the business is a sole proprietorship and the individual also relocates, the individual must file both this form and the standard Form 8822, with the latter handling the Form 1040 and the former handling items such as payroll tax reporting forms (Form 941, 940, etc.).

Section: 6213
Taxpayer Awarded Fees When IRS Refuses to Abate Math Error Adjustment When Taxpayer Files Request Within 60 Days

Citation: Swiggart v. Commissioner, TC Memo 2014-172, 8/25/14

In the case of *Swiggart v. Commissioner*, TC Memo 2014-172, http://www.ustaxcourt.gov/InOpHistoric/SwiggartMemo.Buch.TCM.WPD.pdf, a taxpayer's right to the recovery of administrative and litigation costs following the IRS's stubborn refusal to follow the requirements of IRC §6213.

That provision of the IRC provides that if a taxpayer requests, within 60 days of the receipt of math error notice, an abatement of the adjustment, the IRS is required to abate that adjustment and, if the IRS wishes to pursue the issue, must make use of the standard deficiency procedures with the regard to the disputed item.

In this case the IRS had sent a math error notice to the taxpayer because he had claimed head of household status but had failed to provide the name of the qualifying individual. The taxpayer had not claimed the individual as a dependent because he had signed a release of the exemption to the noncustodial parent. As well, the taxpayer had also shown a balance due on the return initially but had not paid that amount\--so the notice looked to collect that original balance due plus the computed IRS adjustment.

Sixteen days after issuing the math error notice, the IRS computer (in its infinite ability to move forward without regard to niceties like the law) issued a Final Notice of Intent to Levy and Notice of Your Right to a Hearing. Likely this matter was triggered due to the shortfall on the original return, but the issuance of the math error notice was now in the mix as well.

The taxpayer's adviser sent a request for abatement of the math error item 46 days after the original notice to the address on the math error notice and a request for CDP hearing to the person noted to be contacted on the levy notice.

Now things get strange. Rather than abating the adjustment relating to head of household status as a math error (as required by law), the IRS demanded proof of the taxpayer's right to claim head of household status. Abating the adjustment would not mean the IRS could not contest the matter, but that they would have to use the standard deficiency provisions that would allow the taxpayer the rights inherent in that process.

Rather the IRS attempted to simply "roll" this into the CDP process. The IRS continued to demand additional proof and eventually issued a notice sustaining the proposed levy due to lack of proof. The taxpayer next moved on Tax Court, where the IRS initially filed an answer claiming that the CDP hearing provided an opportunity to contest the issue that "cured" the failure to abate the adjustment as required by law—a position rejected by the Tax Court years earlier in the 2005 case of *Freijie v. Commissioner*, 125 TC14.

Eventually the IRS agreed that, in fact, the math error adjustment had to be abated—they could not move forward on that issue at court.

The Tax Court awarded the taxpayer litigation costs in the fiasco, but noted that due to a quirk in the law the taxpayer could obtain virtually no administrative costs. The opinion notes that §7430 allows for recovery of administrative costs incurred on or after the earliest of "(1) the date of the receipt by the taxpayer of the notice of the decision of the IRS Office of Appeals; (2) the date of the notice of deficiency; or (3) the date on which the IRS sends the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals."

The fact that the IRS had not abated the adjustment effectively eliminated the last two trigger dates—so administrative costs could only be counted from the date that the IRS Office of Appeals issued a notice of determination. So, at least for administrative costs, the way the IRS fouled up ended up preventing the taxpayer from having a right to recover unnecessary costs incurred due to the IRS's failure to do the job it was required to do under the law.

Section: 6222
Fifth Circuit Outlines Why Position of Partnership Lacked Substantial Authority Despite Attorney's Opinon Letter

Citation: NPR Investments, LLC v. United States, CA5, 2014-1 U.S.T.C. ¶50,153, 1/23/14

A recent Fifth Circuit Court of Appeals case may help clarify the proper application of the substantial authority standard found in IRC §6662. In the case of NPR Investments, LLC v. United States, CA5, 2014-1 U.S.T.C. ¶50,153, (http://www.ca5.uscourts.gov/opinions%5Cpub%5C10/10-41219-CV0.pdf) the issue of whether substantial authority should be measured at the partnership level and how to measure it was one of the issues under consideration.

The case involved a Son of BOSS partnership structure which the partnership had conceded had no economic substance. Note that this concession was at least partially a strategic decision in the belief that conceding that issue would eliminate the ability of the IRS to assess a valuation misstatement penalty, a belief found to be in error by the U.S. Supreme Court in the case of *United States v. Woods,* 134 S.Ct. 557.

However for this discussion we are concentrating on the applicability of the substantial understatement penalty found at IRC §6662(a), (b)(2). If there is a substantial understatement of tax and the position giving rise to the position does not have substantial authority a penalty equal to 20% of the tax underpayment applies. A taxpayer may only avoid the penalty if either the position had a reasonable basis and was properly disclosed or the taxpayer had reasonable cause for the understatement.

In this case the soon to be partners had sought out the advice of a CPA prior to forming the partnership and the CPA had introduced the CPA to an attorney who eventually gave each partner an opinion letter related to the tax position.

The Fifth Circuit noted that, as both parties to the litigation had agreed, the test of whether a position has substantial authority, being an objective test applied to the underlying law, is an item to be tested at the partnership level since individual partner circumstances will not affect whether or not a position has substantial authority. Specifically, it is not relevant whether or not a partner believed the position had such authority—it either has such authority or it doesn't.

The Court then went on to discuss the existence of substantial authority for the position in question. The appellate panel found that it appeared the District Court had decided the position had substantial authority based on the existence of the attorney's legal opinion letter. Such editorial materials do not provide for substantial authority, so the Court ruled that the District Court must reconsider its ruling to the extent it had decided the authority existed based on mere existence of an attorney's opinion letter—because that is *never* sufficient to establish authority.

Rather, as the Court points out, the analysis found in the letter must be analyzed to determine if the source documents that are allowed to be relied upon in arriving at substantial authority found in Reg. §1.6662-4(d) referred to in the letter provide such substantial authority.

As is generally true for Son of BOSS shelters, the structure relied upon the quirk (prior to 2003) in partnership taxation that contingent liabilities are not liabilities for §752 purposes, and thus do not affect basis. In the shelter this had the claimed effect of magically creating basis out of thin air. The opinion letter referenced to a series of cases tracing back to the 1975 Tax Court case of *Helmer v. Commissioner.* The Court notes that the IRS did not repudiate this position under 2003, after the years in question in this case. Thus the taxpayers had an authority that was still valid and is found on the list of "approved" authorities in the regulation defining substantial authority.

However, as the Court of Appeals points out, substantial authority is not demonstrated by merely finding a single authority (or even a number of authorities) that support a portion of the analysis. In this case the Court points out the *Helmer* case did not address the question of a transaction that lacked economic substance or where the partnership lacked a profit motive.

As well, the IRS had issued Notice 2000-44 that specifically identified this type of transaction as one that was abusive due to lack of actual economic consequences prior to the formation of the partnership. The panel points out that this was an authority that pointed to non-deductibility. The partnership complained this was only the IRS's litigating position and could not constitute authority. However, the Court pointed out that Reg. §1.6662-4 specifically includes notices in its list of authorities to be considered.

And it turns out that the Court found this to be, in some ways, the only relevant authority as it was the only one that dealt with the question of the lack of a profit motive. As such, the existence of this authority at the time of the transaction means the position lacked substantial authority.

While not an issue in this case, the regulations defining "reasonable basis" at Reg. §1.6662-3 do give a safe harbor test that involves finding at least one authority that supports the taxpayer's position that was valid at the time. However, a taxpayer may only fall back to this level of authority to avoid the penalty if there is proper disclosure on the return, generally via a Form 8275 or 8275-R (as applicable). Similarly, it's not clear if the lack of consideration of a profit motive would have lead the Court to find that the *Helmer* cases were inadequate to support such authority—but certainly the taxpayers would have been in a much stronger position.

The Court of Appeals also found that the District Court had erred when it found that, in any event, there was reasonable cause for any resulting understatement. First, the Court found that this was an issue that could differ by partner—that is, one partner could have reasonable cause while another lacked it. So, to the extent the District Court relied on the individual partners' actions as partners, the appellate panel found the Court had no jurisdiction to determine that in a partnership level proceeding.

As well, the Court found that if the Court's position had been that the *partnership* had reasonable cause for the position, it was in error. The Court found there was no evidence to support a finding of reasonable cause for the partnership's position, since the Court only discussed the actions of the individual partners.

Section: 6223
Taxpayer Failed to Provide Notice of Address Change Required by Regulations, IRS Under No Obligation to Mail FPAA to Other Address Using a "Good Faith" Effort

Citation: Estate of Simon v. Commissioner, TC Memo 2013-174, 7/29/13

Does the IRS need to make a "good faith" effort to insure that a final partnership administrative adjustment (FPAA) be mailed to the taxpayer's current address regardless of what steps the taxpayer has taken to notify the IRS? In the case of Estate of Simon v. Commissioner, TC Memo 2013-174 (http://www.ustaxcourt.gov/InOpHistoric/Est.ofSimonMemo.Thornton.TCM.WPD.pdf) the Tax Court decided that the IRS is under no such obligation.

Under IRC §6223(c) the IRS is directed to use the names and addresses listed on the partnership's return to mail out notices unless provided with additional information furnished to the agency by the tax matter partner or any other person in accordance with regulations the IRS may issue.

The IRS has issued such regulations that impose various requirements regarding the notice. The regulation outlines the information that must be contained in the notice provided to the IRS, where the notice is to be filed and requires the notice be received by the IRS at least 30 days before the notice is mailed to the partner.

The case in question involved Temp. Reg. §301.6223(c)-1T, though the relevant language and requirements are the same in the current final regulation.

In this case the taxpayer had not filed such a notice with the IRS. The taxpayer notes that they had filed numerous consents to extend the statute of limitations in the case, and each one listed their new address, which was not the address contained on the original Form 1065.

Nevertheless, the IRS issued a notice to the address shown on the original return seven years after the first document was filed with the IRS showing the new address. The taxpayer argued that the FPAA was thus not valid.

The Tax Court disagreed. The Court noted that while IRC §6223(c)(2) does begin with the provision that "the Secretary shall use additional information furnished to him by the tax matters partner or any other person…" the sentence continues past that point. The remainder of the sentence provides that such information is used "…in accordance with regulations prescribed by the Secretary."

Thus the IRS was under no duty to mail the notice to any address except the one shown on the Form 1065 unless it had been notified, in accordance with the regulations, at least 30 days before the notice was issued. In this case no such notification in accordance with the regulations was ever filed.

Section: 6229
Indirect Partners Not Named on K-1 Subjected to Extended Statute

Citation: Gaughf Properties, L.P., et al v. Commissioner, 139 TC No. 7, 9/10/12, affd CA DC, 12/27/13

The question of whether the statute of limitations remained open for a taxpayer who was an indirect partner in a partnership whose identity was not reported on the partnership's K-1 under §6229(e) was before the Tax Court in the case of Gaughf Properties, L.P., et al v. Commissioner, 139 TC No. 7, http://www.ustaxcourt.gov/InOpHistoric/GAUGHF.TC.WPD.pdf.

The taxpayers in question had participated in a marketed tax shelter. The partnership was a basis creation shelter using options that claimed to be able to offset a large capital gain the taxpayers realized. The taxpayers formed single member LLCs that became partners in the partnership. These SMLLCs were then contributed to the taxpayer's S corporation on the same day as the partnership itself was liquidated, resulting in assets being distributed out of the partnership (which now had the additional basis) coming into the S corporation, leading to a loss on disposition.

The structure resulted in no direct reporting of the partnership on the taxpayer's return. Presumably, such "obscurity" was considered a useful feature of the design in question, not bringing direct scrutiny to bear on the taxpayer's personal income tax return.

The partnership was examined by the IRS, with the IRS proposing adjustments that eliminated the basis step-up. Of course, that merely flowed out to the S corporation which would not itself be a taxpaying entity. By the time this adjustment was made, the normal statute of limitations on assessments against the individual taxpayers had expired.

However, the IRS argued that IRC §6229(e) kept the statute open in this case. That provision provides:

> Unidentified Partner. If --
>
> (1) the name, address, and taxpayer identification number of a partner are not furnished on the partnership return for a partnership taxable year, and
>
> (2)
>
>> (A) the Secretary, before the expiration of the period otherwise provided under this section with respect to such partner, mails to the tax matters partner the notice specified in paragraph (2) of section 6223(a) with respect to such taxable year, or
>>
>> (B) the partner has failed to comply with subsection (b) of section 6222 (relating to notification of inconsistent treatment) with respect to any partnership item for such taxable year, the period for assessing any tax imposed by subtitle A which is attributable to any partnership item (or affected item) for such taxable year shall not expire with respect to such partner before the date which is 1 year after the date on which the name, address, and taxpayer identification number of such partner are furnished to the Secretary.

The taxpayers argued the provision inapplicable for a number of reasons. First the taxpayers argued that because they were indirect partners, their information had not been "omitted" from the return in a form that would trigger this provision. However, the Tax Court, citing the reasoning found in a U.S. District Court decision (Costello v. United States Gov't, 765 F. Supp. 1003 (C.D. Cal. 1991)), found that even though indirect partners are not required to be listed on the partnership return, they nevertheless are subject to the extended statute of IRC §6229(e) until identifying information is provided to the IRS.

Next, the taxpayers claimed they had not reported in a manner inconsistent with the partnership's treatment, thus avoiding triggering IRC §6229(e)(2)(B)'s provisions (and thus avoiding the extended statute). However, the Tax Court found the difference in treatment of the value of the currency options for computing capital contributions by the partnership (where both the long option asset and short option liability were netted) and the taxpayers' treatment of only the long option asset basis, unreduced by the contingent liability on the short option, as being part of their basis was a difference sufficient to trigger IRC §6229(e).

The taxpayers then argued that due to the information provided to the agent during the exam, the IRS had been put on notice of the existence of the indirect partners more than one year before the IRS attempted to assess the tax, falling outside of IRC §6229(e)'s limitation period. The Tax Court pointed out that the regulations require that such information be provided in a form described in Reg. §301.6223(c)-1T.

The Tax Court found the taxpayers had not shown that information had been provided in the required form. The Court also found that while the IRS may have, effectively, over time come into possession of all the information that would have been required to be in such a statement, the IRS was not required on its own to "assemble" those individual pieces.

Finally, the Tax Court did not find the regulation in question to be invalid. The Court found both that the language of the statute itself was not clear on what was meant by "furnishing" this information to the IRS, thus creating the necessary level of ambiguity to allow for IRS interpretation. Second, the Court found that the IRS's particular interpretation found in the regulation was based on a permissible construction of the statute. As such, citing the Supreme Court's decision in the Mayo Foundation (131 S. Ct. 704) case, the Court upheld the validity of the regulation.

The Court of Appeals for the District of Columbia upheld the Tax Court's decision, agreeing that the IRS was not properly notified with regard to the indirect partner. (http://www.cadc.uscourts.gov/internet/opinions.nsf/2577C66AA006401285257C4E0055D1D5/$file/13-1026-1472657.pdf)

Section: 6330
Only Taxpayer, and Not Any "Affected Party", May Pursue Relief in the Tax Court under §6330

Citation: Greenoak Holdings Ltd, et al v. Commissioner, 143 TC No. 8, 9/16/14

In the case of *Greenoak Holdings Ltd, et al v. Commissioner*, 143 TC No. 8, the IRS addressed the issue of whether entities owned by an offshore trust could petition the Tax Court for a notice of intent to levy unpaid estate tax.

The issue involved the estate of James B. Irwin. The Form 706 reported both probate and nonprobate assets. One of the nonprobate assets was Karamia Settlement, an offshore trust to which Mr. Irwin allegedly transferred property to prior to his death.

The estate did not pay the estate tax due on the tax return because it argued it did not have sufficient funds to pay the estate tax. Thus was due to the offshore trust being part of the taxable estate.

The IRS filed a final notice of intent to levy on the estate and the personal representative asked for and received a hearing before Appeals who sustained the proposed levy.

At this point the personal representative did not file with the Tax Court—rather three entities that claimed to be owned by the offshore trust filed a petition with the Court, arguing that since they had property that would be subject to levy they had standing to bring a case in the Tax Court.

The Court needed to determine if these entities were "persons" referred to in IRC §6330, who are the parties that could bring the action in front of the Tax Court. The court notes that the only property subject to levy under IRC §6331 is that owned by the taxpayer and that §6330 therefore gives rights only to the taxpayer to protest the proposed assessment and challenge the IRS in Tax Court.

The Court rejected the view, forwarded by the successor personal representative, that any potentially affected party should have independent rights to proceed under IRC §6330.

Effectively the Court noted that if that view was adopted, there could be an infinite number of potential parties who might be sympathetic to the taxpayer's case that could force separate and distinct cases arguing the same case.

In this case the personal representative did not timely file a court petition. The Court rejected this attempt, a year later, to reopen the matter. While the Court did not give details, it seems likely that the IRS had found some assets it could grab—and that the "offshore" nature of the ownership didn't serve to keep the funds outside the IRS's grasp.

Section: 6330
Taxpayer Who Ignored His Mail Not Allowed to Claim He Never Received Notice of Deficiency

Citation: Onynago v. Commissioner, 142 TC No. 24, 6/24/14

The Tax Court ruled in the case of Onynago v. Commissioner, 142 TC No. 24, (http://www.ustaxcourt.gov/InOpHistoric/OnyangoDiv.Chiechi.TC.WPD.pdf) that a taxpayer who failed to check his mailbox at his mailing address was not entitled to argue he never received a proper notice of deficiency and thus could still contest his tax assessment in Tax Court even though more than 90 days had passed since the notice of deficiency was issued.

It turns out Mr. Onynago wasn't attempting to avoid the IRS in particular—he just didn't check his mailbox very often. While he resided at his apartment approximately 40% of the time, he generally ignored his mail. In fact, the Tax Court noted "the reminder that he often used to pay the utility bills that he received through the Postal Service mail system was the utility companies' disconnection of his utilities for failure to pay utility bills that were due."

However, he was aware there was a tax dispute with the IRS in process. The Tax Court pointed out:

> …he knew that (1) respondent's Appeals Office in Chicago was considering the adjustments that respondent's examining agent had proposed with respect to his taxable years 2006 and 2007; (2) an Appeals officer in that office had contacted him by letter and scheduled a meeting with him to discuss those proposed adjustments; (3) he did not appear at that meeting; and (4) thereafter, in the spring or early summer of 2010, that Appeals officer sent him another letter advising him that if he did not contact the Appeals officer within 20 days, a notice of deficiency would be issued to him for his taxable years 2006 and 2007.

While the taxpayer claimed (not necessarily believably, per the Court) that he did eventually find notices of attempted delivery of certified mail and found the letters had been returned to sender when he went to the post office, the Court that this would not be adequate to support his claim he had not been given proper notice of deficiency.

The Court found that he could not simply ignore the mail and then claim lack of delivery, at least in these circumstances.

Section: 6330
Taxpayer Who Ignored "Absurd" IRS Notice of Deficiency Lost Ability To Challenge Correctness of Liability in CDP Hearing

Citation: Seifert v. Commissioner, Tax Court Order in Docket 24735-12 L, 10/18/13

Ignoring IRS notices is not a good response no matter how "absurd" a taxpayer may believe they are, as the taxpayer in Seifert v. Commissioner, Tax Court order in Docket 24735-12 L, https://www.ustaxcourt.gov/InternetOrders/DocumentViewer.aspx?IndexSearchableOrdersID=114808&Todays=Y.

Mr. Seifert agrees that he had sales of securities that totaled $114 million. He argues (and for the purpose of this order the Court assumes he is correct) that he paid over $113 million for those securities, leading to a gain of $560,811. He asserts (and, again, the Court assumes he is correct for purposes of this order) that he prepared a 2007 income tax return and attempted to electronically file the return.

However, the IRS has no record of such a return being filed. Rather, he was sent a notice of deficiency based on the gross reported sales with no deduction for costs—thus the notice showed a tax liability of $39.8 million, with penalties and interest bringing that total to over $70 million. The Court assumes for purposes of this ruling that the amount greatly exceeds his liability, an assumption that clearly seems to be correct given that the IRS, as always, simply issues a "no cost" assessment when finding a report of sales proceeds not found on a tax return (though this should change over time as the IRS is given basis information from brokers).

The taxpayer conceded he received such a notice of deficiency, but argued that since the notice was clearly not accurate he should be treated as if he hadn't received a notice. That's important because he attempted to get a collection due process (CDP) hearing based not on his inability to pay, but rather disputing the accuracy of the liability.

Unfortunately, IRC §6330(c)(2)(B) provides that a challenge to the underlying liability may only be raised in a CDP hearing if the taxpayer did not previously receive a notice of deficiency or otherwise have an opportunity to challenge the liability. Having admitted he received the notice of deficiency, Mr. Siefert needed to have timely filed a Tax Court petition to challenge the liability. Having failed to do so, he could not use the CDP hearing to raise the issue after the period to challenge the assessment in the Tax Court had expired.

The Court strongly encouraged Mr. Seifert to take the IRS up on its suggestion that he either request audit reconsideration or submit an Offer in Compromise based on Doubt as to Liability—options for relief outside of a CDP hearing, a venue not open at this point for Mr. Seifert to raise the issue he wishes to raise.

Section: 6331
IRS Not Prohibited from Issuing Notice of Intent to Levy During Pendency of Installment Agreement

Citation: Eichler v. Commissioner, 143 TC No. 2, 7/23/14

In the case of *Eicher v. Commissioner*, 143 TC No. 2, http://www.ustaxcourt.gov/InOpHistoric/EichlerDiv.Thornton.TC.WPD.pdf, the issue was what, exactly, IRC §6331(k)(2) prohibits the IRS from doing.

The parts of that provision in question provide:

> (2) Installment agreements
>
> No levy may be made under subsection (a) on the property or rights to property of any person with respect to any unpaid tax -
>
> (A) during the period that an offer by such person for an installment agreement under section 6159 for payment of such unpaid tax is pending with the Secretary;
>
> (B) if such offer is rejected by the Secretary, during the 30 days thereafter (and, if an appeal of such rejection is filed within such 30 days, during the period that such appeal is pending);

The taxpayer's representative submitted a proposed installment agreement in April 2011. In early May the IRS issued a Letter CP 90, Final Notice—Notice of Intent to Levy and Notice of Your Right to a Hearing.

The taxpayer's representative filed a request for a hearing timely and, argued with the request that the Letter CP 90 had been prematurely issued, as the taxpayer had an installment agreement proposal pending when the letter was issued.

It turns out that, for whatever reason, the IRS did not actually enter the status of the installment agreement request into their computer system until June. As well, IRM 5.11.1.2.2.8 directs the IRS Collections Division to rescind notices of intent to levy in various circumstances, including one where the taxpayer has an installment request pending and the taxpayer timely requests an Appeals hearing.

However, the settlement officer determined that, in fact, the letter should not be rescinded. She did determine that she would accept an installment agreement, but only if the taxpayer made a down payment of $8,520.

The taxpayer argued two issues before the court:

- The original letter CP 90 was barred from being issued at the time it was issued and
- The settlement officer abused her discretion by demanding the down payment as a condition for the installment agreement given the financial data provided to her.

The Court concluded that, in fact, all that IRC §6331(k)(2) prohibited was an actual levy by the IRS—and that the IRS had not done that. Rather they had issued the Notice of Intent only.

The Court went on to note that the IRM is not binding on the IRS. As well, the provision in question was directed at the Collections Division and not appeals. As the settlement officer is an appeals officer, she would look towards those provisions in the IRM directed towards appeals. IRM 8.22.2.2.2.2(5) directs Appeals should not rescind a notice of intent to levy while an installment agreement is pending, even if an actual levy is blocked by the statute.

The Court found that the record of the Appeals hearing did not provide enough information to determine if the special financial condition of the taxpayers had been considered, the Court remanded the case to Appeals for an explanation from the settlement officer about the reasons why she found the down payment reasonable given the concerns raised at the hearings with regard to the taxpayer's age and financial condition.

Section: 6332
Bank Liable for Failure to Honor Levy, Despite IRS Putting Taxpayer on Notice of Intent to Levy Bank Account and Taxpayer Taking Funds Less Than 2 Hours After Levy Served on Bank

Citation: United States v. JPMorgan Chase, 2014 TNT 160-12, Docket No. 2:13-cv-03291, US DC Central District of California, 8/15/14

A bank ended up being found liable for failing to act within two hours to freeze a taxpayer's accounts after being served with a jeopardy levy in the case of *United States v. JPMorgan Chase*, 2014 TNT 160-12, Docket No. 2:13-cv-03291, US DC Central District of California.

The situation started when the IRS issued a refund check of $78,169 to a taxpayer that it later determined owed the IRS a significant amount of money. The IRS approved the issuance of a jeopardy levy. An IRS Revenue Officer went to the taxpayer's house at 9:30 am with a levy in hand, and told the taxpayer that he owed the IRS roughly $93,000 and demanded payment.

When the taxpayer did not pay the amount in question the Revenue Officer served the taxpayer with various documents, including notice that the IRS intended to levy his bank accounts.

The Revenue Officer then went to a local bank branch and delivered a levy to an employee of the bank at 9:50 am. At the time the taxpayer had two accounts with the bank, one with just over $40,000 in it and other with a balance of $7,325.

The taxpayer, deciding that he who hesitates may very well be lost in this case, went to a branch of the bank before noon and withdrew $40,000 from the larger account. The bank did not actually freeze his accounts until two days later and, at that time, sent over the remaining balance.

The IRS, not surprisingly, did not succeed in collecting from the taxpayer, so it sought to collect $40,000 from the bank, arguing that it was liable as it had given the funds to the taxpayer after being served with the levy.

The bank argued that it was unreasonable to hold them liable in a case like this when the taxpayer moved so quickly to withdraw the funds in question. Also, the Bank pointed out that while the IRS was required to make a demand for payment to the taxpayer before serving the levy on the bank, the agency was not required to notify the taxpayer that it was going to levy against his assets. The IRS not only did that, but informed the taxpayer which asset (the bank accounts in this case) it would move against.

In the bank's view it should be granted a reasonable time to comply with the levy and, in any event, the IRS agent's ill-advised disclosure of where he was going immediately after being turned down for payment by the taxpayer clearly contributed to the loss of the funds

The Court did not agree. The Court noted:

> Nevertheless, while telling Waterman of the levy itself was clearly improper, there are only two defenses to a violation of 26 U.S.C. § 6332, which holds parties liable for failing to surrender property subject to a levy. First, that the defendant "did not possess any property or rights to property of the taxpayer," and second, that "the property was subject to a prior attachment or execution." United States v. Hemmen, 51 F.3d 883, 887-88 (9th Cir. 1995).

The Court noted that both parties agreed neither of those situations existed in this case. The Court rejected the bank's alternative claims for equitable relief.

Specifically looking at the issue that the IRS should be held culpable for "alerting" the taxpayer of the need for speed, the Court noted:

> The fact of the matter, though, is that the IRS was required to tip Waterman off no matter what. Even when jeopardy assessments are made, the IRS must provide notice of demand for immediate payment before any levy may be imposed. 26 U.S.C. § 6331(a). While this notice does not necessarily inform the taxpayer that bank accounts will soon be levied, it certainly lets them know that something is afoot.

As well, the Court found that there is also no "reasonableness" rule applicable to such levys. The Court noted:

> Moreover, Section 6332 does not contain any reasonableness element that would delay the vesting of the United States' interest in property under a bank's control. The only requirement is that a bank "surrender any property . . . subject to levy" or risk being held liable for the disappearance of that property. 26 U.S.C. § 6332(d)(1). While it is true that the bank need not immediately "surrender" the property, it must upon being given notice preserve that property or run the risk of paying the

> depositor's tax bill. That is the state of affairs here. Waterman's money was "property . . . subject to levy," the IRS agent served the bank with the levy giving it notice of the government's claimed interest in the property, and Chase allowed it to slip away. Section 6332 is therefore applicable.

The Court goes on to note that while the law doesn't mention reasonableness in being liable for the unpaid tax, it does allow a reasonableness defense against penalties for the failures to turn the assets over, meaning that it's clear the law contemplates it's possible for a taxpayer to be liable for the failure to turn over the money but not liable for the penalty—the situation found here.

Section: 6332
Third Party's Responsibilities, Defenses and Potential Liability With Regard to Compliance or Noncompliance With IRS Levy Outlined in Email

Citation: CC Email 201350036, 12/13/13

IRS emails often provide interesting insights into certain processes and issues, but often various details are left out. In the case of CCA Email 201350036 (http://www.irs.gov/pub/1350036.pdf) it appears that a bank was concerned about complying with an IRS levy in a case where the taxpayer claimed an exemption from the levy under one of the provisions of IRC §6334.

The IRS email indicates that a third-party (such as the bank) may not refuse to turn over property subject to a levy by relying on IRC §6334. Rather, it is up to the taxpayer in question to raise such a defense.

The email notes that there are only defenses open to the bank that would excuse a failure to comply with the levy. These are:

- The party on whom the levy is served is not in possession of the property in question *or*
- At the time of the service of the Notice of Levy, the property was subject to attachment or execution under judicial process

If those defenses do not apply, the bank in question must turn over the assets demanded. If the bank fails to do so, it may be held directly liable for the taxes in question and be open to assessment of a 50% penalty under IRC §6332(d) in addition for failing to surrender property without reasonable cause.

The memo also notes that the bank would be held harmless to the customer if honors the levy, pursuant to IRC §6332(e).

Section: 6501
Tax Court Clarifies Calculation of Gross Income Following Home Concrete Decision

Citation: Barkett v. Commissioner, 143 TC No. 6, 8/28/14

Details matter when analyzing court decisions, and that was pointed out to the taxpayers in the case of *Barkett v. Commissioner,* 143 TC No. 6.

The issue in this case is the six year statute of limitations found in IRC §6501(e) and the effect of the U.S. Supreme Court decision in the case of *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012).

In this case the taxpayers had failed to report $629,850 from their 2006 return and $431,957 from their 2007 returns. The omitted amounts related to amounts received for dental services from a corporation they controlled.

The IRS assessments were issued after the expiration of the three year standard statute of limitations on assessments, so the assessment would be valid only if the amounts omitted trip the "25% of gross income" provisions of §6501(e).

The taxpayers had sales of investment assets with gross proceeds of more than $7 million in 2006 and $4 million in 2007, though the reported net capital gains in the years was $123,000 in 2006 and $314,000 for 2007. The issue was fairly simple—if "gross income" reported on the returns included the total sales proceeds, the omitted amounts would not be more than 25%. However, if only the net gains count in this case, then the amounts would be greater than 25%.

The taxpayers argued that the *Home Concrete* decision required using the gross receipts in computing gross income.

As the Tax Court noted, it had, like the Supreme Court, found that the IRS regulations that treated an overstatement of basis as omitted income were invalid—and it did so before the *Home Concrete* case.

But the Court noted that the issue in *Home Concrete* was whether the overstatement of basis amounted to omitted income. Both the Tax Court and the U.S. Supreme Court found that an overstatement of basis was not an omission of income. However, the case did not address what should be included in gross income.

The Tax Court notes that it had considered this issue before. In the cases of *Insulglass Corp. v. Commissioner*, 84 T.C. 203 (1985) and *Schneider v. Commissioner*, T.C. Memo. 1985-139 the Court found that "gross income" must be computed using the reported net gain/loss and not the gross proceeds.

The Court noted the IRC §61(a) defines gross income "as 'all income from whatever source derived', including '[g]ains derived from dealings in property'." The Court found that the separate identification of gains derived from dealings in property means that the net gain, and not the gross proceeds, are what must be used to compute gross income.

The Supreme Court case dealt with the fact that if a sale transaction is reported on the return, but with an improper basis, the item is not *omitted* from the return and thus, with no omission, there cannot be an extended statute.

Since the issue in this case was not related to the investment items, the items in question were omitted. Now that we have omitted gross income, we then move on to the 25% test. And, in this case, they will fail since gross income is measured by looking at the gain reported and not the proceeds.

Section: 6501
Unsigned Partnership Return Does Not Create Open Statute for Assessing Tax Against Individual Partners, Even Though Partnership Return Treated as Invalid

Citation: CCA 201425011, 6/20/14

In Chief Counsel Advice 201425011 (http://www.irs.gov/pub/irs-wd/1425011.pdf) the IRS considers the impact of the filing of a partnership return without a signature on the validity of the return and the ultimate impact on the statute of limitation on assessments.

The matter that led to this memorandum was an LLC that had a signature of unknown origin. Someone signed the return as "Foreign Entity" but the individual who generally acted for the foreign entity indicated that he had not signed nor filed the return, and that someone from the tax preparer's office must have done so.

If that was the case, what is the impact on the validity of the partnership return? The memorandum concluded that, in such a case, the return was invalid since it was not signed, as required by law, by a partner (or, since we are dealing with an LLC, a member of the LLC).

Now the question arose—if no valid return was filed, does this mean that the statute of limitations on assessing tax had not yet begun to run? After all, normally we know the "rule" that failing to file a return means that the statute does not begin to run, so the IRS may assess tax at any time, no matter how many years have passed since the year in question.

The memorandum concludes that, because the actual tax does not get paid by the entity, under §6501(a) it is the return of the individual equity holder that begins the running of the statute of limitation, something that apparently had happened in this case.

Thus, the failure to properly sign the partnership return did not create an extended period of exposure to tax assessment for partnership related issues for the individual partners in this case.

Section: 6501
Taxpayers' Failure to Return "Missing Signature" Return Held to Have Mislead IRS on Possible Expiration of Statute of Limitations

Citation: Reifler v. Commissioner, TC Memo 2013-258, 11/13/13

In the case of Reifler v. Commissioner, TC Memo 2013-258, http://www.ustaxcourt.gov/InOpHistoric/ReiflerMemo.Halpern.TCM.WPD.pdf, the Tax Court had to deal with a statute of limitations issue that was a bit unique.

The taxpayers had filed (or maybe we should say attempted to file) their 2000 income tax returns at the October 15, 2001 extended due date for the return. Unfortunately, apparently in the haste to get the return filed, the wife's signature ended up being left off the return. The Andover IRS Service Center noticed this issue and returned the tax return to the taxpayers.

The return was sent back asking for a signature of the spouse and that it be returned within 20 days. For whatever reason, the taxpayers did not do this. The procedures at that IRS Service Center was not to retain a record of the unsigned return, but to mark the returned copy with a large red "S" along with a stamped received date. That way, when the return came back the center would recognize it as a "missing signature" return and continue processing.

Time went by and in July 2002 the taxpayers received a delinquency notice. In response the taxpayers submitted a Form 1040. That form was identical to the original 1040 except that it was signed by all parties (preparer, taxpayer and spouse) and the dates next to the taxpayers' signatures was August 25, 2002.

An examination followed and in July 2005 the IRS requested that the taxpayers extend the statute of limitations for assessment. The taxpayer's representative provided such a signed consent but sent along with it a cover letter in which they argued the consents were invalid as a matter law, being requested more than three years after the October 15, 2001 date the return with only the husband's signature was sent to the Service Center.

The taxpayers argued that, based on prior case law, so long as Mrs. Reifler intended to file a joint return, a return signed only by Mr. Reifler represented a validly filed return. In those cases the IRS had been attempting to hold the non-signing spouse jointly liable for a deficiency. The Court had agreed in those cases the spouse was liable if he/she had intended to file a joint return even if he/she had failed to sign the return.

The IRS argued those cases were not applicable, as the argument was not with regard to a statute of limitation but whether a joint return election had been made. In the IRS's view the cases never addressed whether the returns were valid for starting the statute of limitations and that, effectively, this was a doctrine only the government could use in its favor.

The Court declined to address that issue, instead determining that it could resolve the case on other grounds of equitable estoppel. Under those grounds, a litigant would be prohibited from raising an argument in its favor if it could be shown that

- There had been a false representation or misleading silence
- The error was one of fact, not an opinion or statement of law
- The party arguing for equitable estoppel must not have been aware of the facts and
- The party arguing for estoppel must be adversely affected by the actions of the other party

The Court found that the filing of the second 1040 with an August 2002 signature date was a false representation, leading the IRS to believe the return represented the taxpayer's first return. The question of whether the original return began the tolling of the statute of limitations was not raised by the taxpayers' representative or the taxpayers until after the original statute date would have passed.

The issue was clearly one of fact (either the return was filed in October 2001 or it was filed in August 2002), so that prong was met.

The taxpayers argued that the IRS was aware of the original return, and only their negligence in failing to keep track of this fact caused the IRS to come to the erroneously conclusion the statute ran into 2005 and did not expire in 2004. The Tax Court held the IRS was under no obligation to note the original return, since the Center had sent a copy to the taxpayer flagged in a way to make it clear it was a missing signature return. Had the taxpayers complied with the request to send back the form with the missing signature within 20 days the IRS would have had the record.

The taxpayers argued that it was "well known" other Service Centers did keep records of such returns. The Tax Court found that the taxpayers showed no evidence that the IRS had a formal policy requiring such retention and thus did not hold the procedures of other service centers (assuming the taxpayers could show such procedures) would be held against the IRS in this case.

Section: 6501
Courts Split on Question of Who Must Have Intent to Commit Fraud to Trigger §6501(c)'s Unlimited Statute on Assessing Tax

Citation: BASR Partnership v. United States, 2013-2 USTC ¶50,527, US Ct. Claims, 9/30/13, City Wide Transit, Inc. v. Commissioner, CA2, 2013-1 U.S.T.C. ¶50,211, reversing TC Memo 2011-279, 3/1/13

The implications of the provision found in IRC §6501(c) regarding the statute of limitation on assessing tax when the IRS is faced with a fraudulent tax return is generating much action and disagreement among the courts about exactly whose fraudulent intent can trigger the extended statute and what the nature of such a fraud must be to do so. Since triggering §6501(c) gives the IRS an unlimited period of time in which to assess the tax, the matter is one of true concern if, truly, a taxpayer may find him/herself stuck with the statute due to a fraud committed that they weren't aware of.

ALLEN CASE

The case that began this saga is the 2007 case of *Allen v. Commissioner*, 128 TC No. 4 (http://www.ustaxcourt.gov/InOpHistoric/vallen.TC.WPD.pdf). In the *Allen* case the preparer had prepared a return containing false and fraudulent deductions which served to reduce the taxpayer's tax. While the taxpayer signed the returns, the IRS conceded that the taxpayer did not have fraudulent intent, apparently not reviewing these items on his return.

In *Allen* the Court held that as the return itself was fraudulent, the taxpayer had to face the consequences of that fact with regard to the assessment. The court noted that:

> "We do not find it unduly burdensome for taxpayers to review their returns for items that are obviously false or incorrect. It is every taxpayer's obligation. Petitioner cannot hide behind an agent's fraudulent preparation of his returns and escape paying tax if the Government is unable to investigate fully the fraud within the limitations period."

As such, the IRS was given the benefit of the unlimited statute for assessing the tax. The court held that "to find otherwise would allow a taxpayer to receive the benefit of a fraudulent return by hiding behind the preparer."

Advisers must note that this is a published Tax Court decision (see the citation above) and thus the Court indicates that it will apply this standard for all future similar cases. This has significant implications when an adviser takes on a taxpayer who may have unwittingly used a "less than honest" adviser in prior years.

CITY WIDE TRANSIT CASE

In the case of *City Wide Transit, Inc. v. Commissioner*, TC Memo 2011-279 (http://www.ustaxcourt.gov/InOpHistoric/CityWideTransit.TCM.WPD.pdf), the Tax Court attempted to limit the implications of fraud on the part of a tax preparer on the statute of limitations for the IRS to assess a tax—but the Second Circuit disagreed with the Tax Court, finding that the IRS could proceed with assessing unpaid payroll taxes (2013-1 U.S.T.C. ¶50,211, http://caselaw.findlaw.com/us-2nd-circuit/1623267.html).

In *City Wide Transit* we again have a fraudulent preparer, but a number of different facts lead the Tax Court to a different conclusion. In this case the taxpayer had run into difficulties with the IRS regarding unpaid payroll taxes. The taxpayer engaged an individual who claimed to be a certified public accountant, though it turns out he was not. However this would not be the last, or the most significant, falsehood this representative would put before this taxpayer or the IRS.

The accountant had the taxpayer sign a blank power of attorney form. The accountant informed the taxpayer that he had negotiated a settlement with the IRS, but that a condition of that settlement was that the accountant would have to personally deliver the Forms 941, along with certified checks for the tax due, to the IRS each quarter from now on. In reality nothing of the sort had taken place.

Each quarter the accountant would receive the properly prepared and signed Form 941 from the taxpayer along with a check for the balance due, payable to the IRS. The accountant would prepare a substitute Form 941 he would sign that showed the taxpayer had paid a large sum in advance earned income credit to employees in the quarter and thus show a much smaller balance due. The accountant then altered the check he received, deposited it into an account he controlled, and wrote a check to go with the Form 941 for the much smaller amount of tax due.

He also "solved" the problem of the unpaid earlier taxes by preparing amendments to the prior Forms 941, again claiming large amounts of advance earned income tax credit payments. He then paid out of the funds from the account he was depositing the checks into the much reduced balance.

In reality, the accountant was simply running an embezzlement scam on the taxpayer, a scam that eventually netted him $280,000 of diverted funds. Eventually he was caught and convicted of a number of crimes, including violating of IRC §7206(1) of the IRC regarding tax fraud.

The IRS opened up a civil case against the taxpayer to recover the lost funds, eventually issuing assessment after the end of standard three year limitation on assessing the tax. The IRS argued, relying on *Allen*, that the statute remained open due to the fraudulent returns filed on behalf of the taxpayer.

The IRS argued that the statute remained open, relying on IRC §6501(c)(2) that the accountant's actions represented a willful attempt to evade tax. The Tax Court disagreed. The Court found that the accountant had filed false tax forms, but not primarily with the goal of evading taxes, but rather solely to cover up the embezzlement program he was carrying out. The goal had been to steal from the taxpayer, and only incidental to that primary goal was the IRS deceived.

However, the Second Circuit found that the Tax Court had clearly erred in determining that the accountant intended to evade City Wide's taxes, even though it was to benefit himself rather than the taxpayer. The Second Circuit found fault with the Tax Court's determination that evading the tax was a secondary or incidental effect of the scam—rather, it was crucial that the taxes be evaded in order for the accountant to pocket those funds that his client believed had been used to pay payroll taxes.

The appellate panel did outline what it found was an example of a different sort of fraud that would not lead to this conclusion. The court stated:

> This would be another case if, for example, Beg falsely recorded certain personal expenses as corporate expenses on City Wide's ledger that in turn caused City Wide to file a tax return that fraudulently understated its income. If that had been the case, Beg's fraud on the company would have caused the company to file a false return, and we would not assume that the company intended to evade a tax by filing that false return. Here, however, Beg's actions were not as secondary or remote to the fraudulent returns as the tax court suggested; Beg was not a third party unrelated to the preparation and filing of the returns.

The case emphasizes problems that arise when a taxpayer gets involved with a "bad apple" adviser. It also suggests that keeping a watchful eye on any third parties involved with tax filings for an individual or organization is a key responsibility of the taxpayer. This case makes clear that a "rogue" payroll service could expose the organization to liability for taxes going back for as long as the rogue service can continue to keep a lid on the problem.

Advisers that inherit clients who have been in such situations need to counsel the client about this issue hanging over the taxpayer, and the implications of the continuing daily compounding of interest on the tax that was not paid—compounding that can make paying off the balance due much more costly if the taxpayer decides to "hope" the issue is never raised, only to find their hope misplaced years down the line. Thus advisers must be sure to document that they both advised the client of the option to amend and pay the tax due. Failure to document that fact can lead to problems not only with various regulatory agencies should the client claim never to have been informed of the possibility to amend (the Office of Professional Responsibility for one would be interested), but also exposes the CPA to a civil liability claim raised by the taxpayer looking to be reimbursed for the "excess" interest that is going to pile up under daily compounding.

As well, the IRS has now released a "Fact Sheet" (Fact Sheet FS-2013-9, http://www.irs.gov/uac/Newsroom/Tips-for-Employers-Who-Outsource-Payroll-Duties) describing what steps businesses should take to protect themselves from a situation like this.

BASR PARTNERSHIP CASE

However, there is not agreement that the question of fraud on the part of someone other than the taxpayer is relevant. The Court of Claims voiced its contrary opinion, specifically rejecting the *City Wide Transit* and *Allen* analysis in the case of BASR Partnership v. United States, 2013-2 USTC ¶50,527, US Ct. Claims (http://www.uscfc.uscourts.gov/sites/default/files/BRADEN.BASR093013.pdf).

The BASR case involved a partnership tax shelter where the deal had been structured by an attorney who, it was conceded for the case, had the requisite fraudulent intent in structuring a deal leading to the return in question. It was also conceded that the individual partners in this case did not have such fraudulent intent.

Since the normal three year statute had lapsed, the IRS was attempting to save the case by arguing that the return itself, due to the work of the advising attorney, was fraudulent, thus triggering the extended statute of limitations under IRC §6501(c)(1).

The taxpayers had a couple of arguments against this. They first pointed out that this was a partnership proceeding which also brought IRC §6229 into the analysis of the statute of limitations. IRC §6229(c)(1) provides its own fraud rule, which provides that:

> (1) False return.—If any partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item—
>
> > (A) in the case of partners so signing or participating in the preparation of the return, any tax imposed by subtitle A which is attributable to any partnership item (or affected item) for the partnership taxable year to which the return relates may be assessed at any time, and
> >
> > (B) in the case of all other partners, subsection (a) shall be applied with respect to such return by substituting "6 years" for "3 years".

Thus, they argued, since this statute specifically requires that a PARTNER have intent to evade tax, it should override the standard rule at §6501(c).

The Court of Claims rejected this analysis, noting that §6229 provides a minimum period for the statute, but does not override IRC §6501's general statute of limitations. Thus, effectively, it can only extend the statute but cannot shorten it. Under this view, if the *Allen* and *City Wide* analysis is correct, the taxpayer would be out of luck.

But the Court of Claims did not accept the view that the question was whether the return was fraudulent, not whether the taxpayer had fraudulent intent. The Court rejected the analysis in *Allen* and *City Wide* and instead found that the statute clearly contemplated a fraudulent intent on the part of the taxpayer in order to open the statute.

The Court agreed with the IRS complaint that the existence of fraud, regardless of who perpetuated it, made it much more difficult to uncover tax understatements, but held that fixing that problem was not a matter for the courts. Rather, the IRS must go to Congress to get the statute changed.

Advisers should note that this decision is a trial court decision, and that it is very possible the IRS might decide to ask the Federal Circuit to overturn the ruling. But it also means that we may see other courts decide to strike out against the *Allen* analysis, as it seems that even the Tax Court decided that it produces utterly unfair results when that Court tried (unsuccessfully) to extract the taxpayer in *City Wide* from its application.

Section: 6503
IRS Failed to Show Taxpayer Was Truly Residing Outside the United States

Citation: Reinhart v. Commissioner, TC Memo 2014-218, 10/16/14

In the case of *Reinhart v. Commissioner*, TC Memo 2014-218, the IRS was contending that even though it had been far more than ten years since the tax had been assessed, the IRS could still levy against the taxpayer to attempt to collect a trust fund recovery penalty.

The IRS took this position because the agency claimed that Ms. Reinhardt was outside of the United States continuously for an extended period of more than 6 months. Under §6503(c) the statute is suspended during such periods.

There was no question that Ms. Reinhart's spouse resided in Bahamas. There was also no question that Ms. Reinhart traveled to the Bahamas during that period.

But the taxpayer (and the Tax Court) found that the mere fact Ms. Reinhart went to Bahamas quite often did not mean that she was outside the United States for the requisite periods.

Ms. Reinhart produced testimony from other individuals that she lived in the United States primarily during the years in question. As well, records obtained from the Department of Homeland Security showed regular trips between Florida and the Bahamas. The Tax Court found Ms. Reinhart a credible witness and that the objective evidence supported her contention that she was not residing outside of the United States.

The IRS argued that the fact that Ms. Reinhart made transactions by mail or wire and used a mailbox service indicated that she was not residing in the United States. However the Tax Court found that evidence to be explained by Ms. Reinhart and not sufficient to show she was residing outside the United States.

Section: 6510
Issues That Occur When LLC Taxed as Partnership Ends Up With a Single Owner Outlined in IRS Memorandum

Citation: CCA 201351018, 12/20/13

To be a partnership, there must be partners (that is, plural). If an entity ends up only a single "partner" then it is no longer a partnership.

If that entity is a limited liability company (LLC), some issues arise in this case for tax matters, issues that are outlined in Chief Counsel Advice 201351018 (http://www.irs.gov/pub/irs-wd/1351018.pdf).

The ruling points that even though the income tax entity switches from a partnership to a sole proprietorship at this point (so that income is reported on the remaining owner's individual return on Schedule C rather than Schedule E), for payroll tax purposes the LLC continues to report using its own EIN pursuant to Rev. Rul. 2001-61. Despite the "check the box" status change, the LLC always reports.

However, the partnership will terminate once there is only a single partner. In the case at hand one partner bought out the interest of the other, and the old partner became an at-will employee. In the case at hand it appears that the entity continued to report the income and expenses on Form 1065. While that is not correct, the memorandum pointed out to the examining agent that, depending on how the K-1s were prepared, the remaining owner may have effective reported all income, including self-employment income, albeit on the wrong forms.

The remaining owner of the entity would be the person to sign consents to extend the statute for the payroll tax returns. As the notice points out, the proper entity filed those returns and the remaining owner is the person authorized to act on that entity's behalf.

Exam also needed to issue a notice to reclassify the second partner as an employee per the memo. The memo provided that the notice in that case should be issued to the remaining owner of the LLC.

Section: 6511
Use of the Wrong Form for an Innocent Spouse Claim for Refund Did Not Qualify as Informal Claim, Perfected Claim Filed After Closing of Statute of Limitations

Citation: Palomares v. Commissioner, TC Memo 2014-243, 12/2/14

The IRS agreed that Teresa Palomares would have qualified for innocent spouse relief related to the application of her 2006 refund against 1996 joint tax liabilities. However, the question to be decided in the case of *Palomares v. Commissioner*, TC Memo 2014-243, was whether Teresa's filing of the wrong form within the statute of limitations period for claiming the refund served as an informal claim since she did not file the proper form until after the statute would have normally expired.

In the case in question Teresa found that her refunds from 2006 and 2007 were being applied against outstanding tax liabilities that arose from a joint return she filed with her husband for that year.

She separated from her husband in 2005 and obtained employment at that time. For 2005-2007 she filed separate returns from her husband. She spoke very little English and had not been involved in handling the tax matters when she been living with her husband. However, when she failed to receive her refunds from 2006 and 2007 she sought assistance from a legal clinic.

The clinic erroneously advised Teresa to file Form 8379, a form asking for relief for an injured spouse, for 2007. That form is used to divide up tax liabilities from a joint return. The IRS returned the form to Teresa in September of 2008, sending along a letter (in English) that stated she was ineligible to use Form 8379 since she had not filed a joint return for 2007 and suggesting that she might qualify to file for innocent spouse relief, including a Form 8857 with the letter.

Unfortunately, Teresa's limited understanding of English resulted in her only discerning that she wasn't going to receive the requested refund, but not why she wasn't to receive it. She therefore did not file the Form 8857 at that time, nor did she bring suit to contest the denial of her refund.

Eventually she did prepare and file a Form 8857, but not until August 2010. She did so because the attorney who handled her divorce informed her why the refund request had been denied and that she needed to file the innocent spouse form. On that form she sought relief for 2005, 2006 and 2007.

However, under IRC §6511 a claim for refund must be brought within three years from the date the return was filed or two years after the tax was paid—thus, only the 2007 return year was still available for a refund to be claimed unless the statute had been held open by a filing before statute had expired for 2005 and 2006.

The law does recognize the concept of an "informal claim" for refund that can serve to hold the statute open despite not being in the form necessary to actually claim the refund. Generally such an informal claim must provide the government with fair notice of the basis for the claim for refund. Ms. Palomares argued that her filing of the injured spouse claim in 2008 (well within the statute of limitations for claiming a refund of 2005 and 2006 taxes) should serve as an informal claim.

The Tax Court, while sympathetic to her numerous problems (aside from a limited understanding of English, begin abused and threatened by her soon to be ex-husband, a custody battle, an extremely ill father located out of state and garnishment of her wages due to liabilities of her former spouse's business), found that the Form 8857 was simply inadequate to give the IRS fair notice of the nature of her claim.

The Tax Court noted that to qualify as an informal claim, the claim must meet three tests:

- The writing is delivered to the Service before the expiration of the applicable period of limitations,
- The writing in conjunction with its surrounding circumstances adequately notifies the Service that the taxpayer is claiming a refund and the basis therefor, and
- Either the Service waives the defect by considering the refund claim on its merits or the taxpayer subsequently perfects the informal refund claim by filing a formal refund claim before the Service rejects the informal refund claim

There was not question the Form 8857 was filed prior to the closing of the statue. However, the Court found that the Form failed the second test—it did not provide adequate information about the refund she was claiming and the basis for the refund.

The Court notes that the Form 8857 did not ask for relief from application of a refund against the 1996 tax year. Rather, it simply asked for an allocation of items reported on her 2007 income tax return, not only failing to mention the 1996 tax liability, but also not mentioning any issue with the 2005 or 2006 returns, which are the years facing a closed statute of limitations.

Ms. Palomares argued that the letter from the IRS suggested she likely should be filing an innocent spouse claim indicated that the IRS had conceded the agency knew that the matter was truly an innocent spouse claim regarding the application of the refund. However, the Court held:

> Though respondent's September 24 letter notes that petitioner may have intended to file a Form 8857 and a copy of that form was included with the letter, this courtesy cannot be construed as reflecting Respondent's awareness that petitioner was seeking a refund based on a request for relief from joint and several liability for the 1996 year.

The Court noted that an informal claim that fails the three-prong test above may nevertheless be granted standing based on equitable grounds. However the Court did not find that such grounds existed in this case. The Court noted "While we are sympathetic to petitioner's situation and the hardships she faced in her personal life, finding that her Form 8379 was an informal request for refund based on relief from joint and several liability would place an unfair burden on the Government." The opinion continues:

> Although petitioner was incorrectly advised to submit a Form 8379 to obtain a refund of amounts applied against the 1996 tax liability, her Form 8379 did not reference 1996 and would require Respondent to research years other than the year 2007 which was included on the Form 8379. If we were to hold that respondent was on notice on the basis of those facts, such a result would place an unreasonable burden on the Government. While the informal claim doctrine provides for equitable relief, to find that petitioner's Form 8379 qualifies as an informal claim would stretch the doctrine beyond reasonable boundaries.

The Court closes by noting that the IRS agrees the taxpayer is entitled to innocent spouse relief for 2007 and that she was no less an innocent spouse for the earlier two years. But it found she simply failed to ask for relief in time to obtain it for those years.

Section: 6621
Merged Corporations Allowed to Use Interest Netting Rules for Pre and Post Merger Tax Overpayments and Underpaymetns

Citation: Wells Fargo & Company v. Commissioner, No. 11-808T, 2014 TNT 125-13, 6/27/14

The question of what is the "same taxpayer" for purposes of the interest netting rules of IRC §6621 was address by the United States Court of Federal Claims in the case of Wells Fargo & Company v. Commissioner, No. 11-808T, https://ecf.cofc.uscourts.gov/cgi-bin/show_public_doc?2011cv0808-72-0.

The case in question involved various entities which, through statutory mergers, eventually became part of Wells Fargo & Company. For certain years prior to the mergers there were both tax overpayments by some of the companies and tax underpayments for others. For the years in question the various corporations had filed returns under different employer identification numbers.

The issue is significant because a higher interest rate is imposed on underpayments than is paid on overpayments—so if no netting is allowed, the IRS would effectively receive a "bonus" on the amount of the underpayments. IRC §6621(d), enacted in 1998, allows for netting of such overpayments and underpayments for purposes of computing interest to address that disparity.

The netting is allowed if the overpayments and underpayments relate to the same taxpayer. However, as the Court of Claims note, the issue of who exactly in the same taxpayer in the context of a statutory merger had not previously been addressed.

The IRS position in the case is that the "same taxpayer" requires that the entities whose overpayments and underpayments are netted must have filed returns using the same employer identification number. Wells Fargo takes the position that following a merger, the previous companies become the "same taxpayer" for federal tax purposes even though they may used separate EINs on the various returns filed.

Prior cases had held that members of affiliated groups filing consolidated returns were not the same taxpayer when activities related to years prior to the parties being members of the affiliated group (see *Energy E. Corp. v. United States*, 645 F.3d 1358 (Fed. Cir. 2011), and *Magma Power Co. v. United States*, 101 Fed. Cl. 562 (2011)). The IRS position was that the same result should hold following a merger.

The Court of Claims agreed with Wells Fargo that a merger is different. While the parent and subsidiaries in an affiliated group retain their separate legal identities, in a merger the combined entities become one and the same corporation. As the opinion notes:

> Because the surviving corporation steps into the shoes of the acquired entity and the surviving corporation is liable retroactively for the tax payments of its predecessors, it does not matter when the initial payments were made. Put another way, following a merger, the law treats the acquired corporation as though it had always been part of the surviving entity.

The loss of the TIN is not relevant in a merger, because the combined entity becomes liable for any taxes of the prior, uncombined entities.

The Court goes on to point to various IRS positions issued over the years that have held, for various purposes, that the merged corporations are treated as the same taxpayer going forward.

Section: 6501
IRS Not Required to "Piece Together" Hints Regarding Omitted Income, Taxpayer Hit with Six Year Statute of Limitations

Citation: Heckman v. Commissioner, TC Memo 2014-131, 6/30/14

In the case of *Heckman v. Commissioner*, TC Memo 2014-131, http://www.ustaxcourt.gov/InOpHistoric/HeckmanMemo.Dawson.TCM.WPD.pdf, the question of adequate disclosure of omitted income was addressed for purposes of avoiding the six year extended statute under IRC §6501(e)(1)(A).

The taxpayer's only defense in this case was that he had adequately disclosed a potentially taxable IRA distribution in 2003, having conceded that if the taxpayer did qualify for the disclosure exception to the six year statute under IRC §6501(e)(1)(A), the entire amount being assessed by the IRS for tax related to a rather poorly operated ESOP plan and its distribution and rollover to his IRA was due.

IRC §6501(e)(1)(A) provides that the standard three year statute of limitation is expanded to six years if the taxpayer omits more than 25% of the amount of gross income properly included in the return. This is a mechanical test, and the amount of omitted income clearly exceeded that amount.

However a taxpayer can escape this provision if the taxpayer can show, under IRC §6501(e)(1)(A)(ii), that the taxpayer disclosed the item of potential income either in the return or on a statement attached to the return, in a manner sufficient to apprise the IRS of the nature and amount of the item.

The taxpayer did not specifically include any reference on his return to the existence of a potential problem with the ESOP and/or the existence of any sort o distribution (rolled over or not) to the IRA. However the taxpayer argued that the IRS had access to other documents that should have served to apprise the IRS of the potential issue.

He argued that statements on a partnership return, which became an asset held by the purported ESOP plan, indicated that:

- The Schedule K-1 attached to the partnership's return that identified the partner as the taxpayer's IRA;
- The Form SS-4, was filed to obtain a taxpayer identification number for the partnership, identified the taxpayer as "general managing member" of the LLC; and
- The Form 5498 filed for the IRA, which lists the taxpayer as the owner of the nominee account held by the custodian

The taxpayer argues that this information, taken as a whole, effectively should have put the IRS on notice for a possible distribution.

The Tax Court disagreed. The opinion notes:

> To the contrary, no statement on any of those documents offers any "clue" as to the existence, nature, or amount of the omitted income. At best, they reveal only that petitioner and/or his IRA are members of [the partnership.]

The taxpayer argued that his case was comparable to the situation the taxpayer faced in the case of *Benderoff v. United States*, 398 F.2d 132 (8th Cir. 1968). However, the Tax Court found the case distinguishable.

> In *Benderoff*, the taxpayers' individual return specifically referred to their income derived from a subchapter S corporation, clearly stating the name of the corporation and the amount of their share of the corporation's undistributed corporate income. Therefore, the Court of Appeals looked beyond the taxpayer's individual return. Here, in contrast, petitioner stipulated that he did not disclose his participation in the ESOP or its distribution to his IRA on his 2003 return or in any statement attached thereto. Consequently, we reject his assertion that we may look beyond his individual return because we do not believe that the return offered the necessary "clue" required to disclose the omitted income.

The court also rejected two other theories of the taxpayer. First, the taxpayer claims that he gave information on the transaction by communicating it the IRS during the examination of his 2007 return that eventually lead to the assessment against 2003. Second, though the IRS was aware of existence of the issue based on that communication, it nevertheless failed to assess the tax within three years.

The Court held that:

> Even if petitioner provided such oral notice, the notification given three years after a return is filed is not a disclosure "in the return, or in a statement attached to the return", as required by section 6501(e)(1)(A)(ii). Moreover, any delay by the Commissioner after receiving such late oral notice of an omission of gross income does not invalidate a notice of deficiency sent before the expiration of the six-year period when it otherwise applies.

In short, the Tax Court refused to credit the taxpayer with other documents (he also tried point to late filed Forms 5500 in a final attempt to claim disclosure that the Court rejected).

Section: 6651
Taxpayer Failed to Show Reasonable Cause for Late Filing of Tax Return

Citation: Estate of Stuller v. United States, USDC Cent. Dist. IL, Case No. 3:11-cv-03080, 7/22/14

What constitutes reasonable cause for late filing of a return? While you might think death would constitute a reasonable cause, the Court in the case of *Estate of Stuller v. United States*, USDC Cent. Dist. IL, Case No. 3:11-cv-03080, http://scholar.google.com/scholar_case?case=12944356091874452267&q=estate+of+Stuller&hl=en&as_sdt=806.

The case involved issues related to whether the Stullers had a profit motive for horse breeding business (the court found they did not) and the question of whether there existed reasonable cause for the late filing of the taxpayers' 2003 tax return.

On January 6, 2003 a fire destroyed the Stuller's home and Mr.Stuller died of injuries suffered in that fire on January 8, 2003. Mrs. Stuller developed double pneumonia and was hospitalized for a number of weeks. Due to the extensive damage of the home, Mrs. Stuller rented and lived in an apartment from February 1, 2003 until January 31, 2004. At that time she relocated into one of her rental properties.

The couple's 2003 return was not filed until February 20, 2005, months after the extended due date of the couple's 2003 tax return of October 15, 2004.

Mrs. Stuller argued that a number of factors had served to prevent her from timely filing that return. They included:

- The fire caused the loss of a portion of the tax records stored at the home

- The records that did survive were relocated to a separate location in unmarked boxes that made it difficult to access even records not destroyed
- Following the fire, which resulted in the death of her husband and her own hospitalization, Mrs. Stuller suffered from stress and depression. Other illnesses also impacted Mrs. Stuller following these events, including chronic bronchitis.
- Mrs. Stuller also became very disorganized and was unable to even open the mail some days
- As well, there arose health and behavior problems with Mrs. Stuller's granddaughter of whom she had legal custody
- As well, there was the additional work needed due to Mr.Stuller's death by the attorneys and accountants to fund up the trusts, resulting in additional delay.

While an impressive list, the IRS noted counter-evidence that indicated there was not reasonable cause for late filing.

- Mrs. Stuller was able to timely file the 2002 return. That return was due during 2003, the year of the tragic events.
- Mrs. Stuller participated in horse shows during 2003 and 2004.
- Mrs. Stuller continued to actively and successfully manage the couple's business which involved the ownership of a number of Steak 'n Shake franchises. She fired the old director of the business and hired a new director with whom she regularly consulted.

The Court sided with the IRS, finding that the taxpayers had not carried their burden to show reasonable cause. The mere existence of the tragedy was not, by itself, sufficient cause to justify late filing.

While the Court conceded that destruction of records could qualify in the proper situation, the taxpayers had shown that they had made a diligent but futile effort for an extended period before the deadline to locate records from which to prepare the return. Thus, the Court found that there was no reasonable cause demonstrated by the taxpayers for the late filing.

Section: 6656
Penalty Applies Due to Failure to Use EFTPS Despite Making All Deposits Timely

Citation: Commonwealth Bank and Trust Co. v. United States, DC KY, No. 3:13-cv-01204, 2014 TNT 131-12, 7/3/2014

A bank's attempt to argue "no harm, no foul" for failing to electronically deposit taxes when required fell on deaf ears in the case of *Commonwealth Bank and Trust Co. v. United States*, DC KY, No. 3:13-cv-01204, 2014 TNT 131-12.

The parties in the case agreed upon much, and the Court summarized those as follows:

> There is no dispute that Commonwealth's tax obligation, on the occasion in question, was in excess of $200,000, and that 26 C.F.R. § 31.6302-1(h)(2)(ii) required Commonwealth's payment to be by EFT. There is also no dispute that the IRS furnished deposit forms to Commonwealth, and that Commonwealth erroneously used those forms to deposit its tax obligation rather than using an EFT. Commonwealth's deposit was timely, and in the full amount due.

The bank argued that the penalty applies only to an underpayment and since it timely deposited the taxes (albeit in the wrong manner) there is no amount on which to apply the penalty under IRC §6656.

The Court, however, notes that the argument has been rejected by a number of courts before on the grounds that is inconsistent with both the plain language and purpose of IRC §6656's mandate of electronic filing. The Court in this case found no reason to find fault with those earlier rulings.

Therefore the Court held:

> Because it is undisputed that Commonwealth failed to make its deposit by ETF in accordance with 26 C.F.R. § 31.6302-1(h)(2)(ii), the Court will grant the motion to dismiss Count One of Commonwealth's Complaint.

Or, effectively, to rule that the bank did owe the penalty due to failure to use the proper method to deposit its taxes despite timely making all deposits.

Section: 6662
IRS Allowed to First Assert Substantial Understatement Penalty in Tax Court Answer

Citation: Tax Court Order, Illinois Tool Works v. Commissioner, Case No. 10418-14, 12/2/14

Pursuing the process of challenging an IRS determination is not without risks, one of which is that the IRS may decide to assert issues later in the process that the taxpayer believed had been "handled" at the original exam level. In a recent Tax Court order in the case of *Illinois Tool Works v. Commissioner*, Case No. 10418-14, the issue involved a taxpayer's liability for penalties under §6662(d).

IRC §6662(d), better known as the substantial underpayment penalty, applies when two criteria are met:

> (d) Substantial understatement of income tax.
>
> > (1) Substantial understatement.—
> >
> > > (A) In general. For purposes of this section , there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of—
> > >
> > > > (i) 10 percent of the tax required to be shown on the return for the taxable year, or
> > > >
> > > > (ii) $5,000.
> > >
> > > (B) Special rule for corporations. In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of—
> > >
> > > > (i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or
> > > >
> > > > (ii) $10,000,000.

The penalty is 20% of the understatement in question. While the burden is on the IRS initially to show that penalty applies, all the IRS need to prove is an understatement exceeds those trigger limits.

The penalty may only be waived if:

- The position in question had substantial authority (something it will difficult to convince an agent of in most cases when the agent has disallowed the deduction);
- The position had a reasonable basis and was disclosed properly on the return (normally via a Form 8275 or 8275-R); or
- The understatement was due to reasonable cause and the taxpayer had acted in good faith to determine his/her tax liability.

While the burden is on the IRS to show that the penalty applies, once the IRS has shown that (which just means, for this penalty, showing that the trigger levels of understatement have been reached) the burden shifts to the taxpayer to show any possible relief provision applies.

In this case the IRS was challenging a transfer of funds from a foreign subsidiary, which it contended was a taxable dividend. On exam the IRS had determined a deficiency of over $70 million but had not asserted a penalty under §6662(d) though the understatement clearly exceeded the criteria for the penalty to apply.

The taxpayer filed a petition in Tax Court challenging the $70 million plus tax bill. The taxpayer believed the understatement had been resolved on exam. The order, reciting the taxpayer's claim, notes:

> In moving to strike these paragraphs from the answer, petitioner notes that neither the IRS examination team nor the IRS Appeals Office proposed to assert an accuracy--related penalty with respect to the issue currently in dispute, whereas the IRS did propose to assert this penalty with respect to another audit issue that has since been resolved.

However, in the answer to the taxpayer's petition to the Tax Court, the IRS asserted the penalty under §6662(d) applied in this case.

The taxpayer argued that since the IRS had not asserted the penalty in the original determination of tax, it was blocked from raising the issue when the case when to the Tax Court by the Administrative Procedures Act (APA).

The Tax Court disagreed. The Court noted:

> Our Rules explicitly permit respondent to assert an increased deficiency or "new matter" in his answer, Tax Court Rule 142(a), and Congress has specifically granted this Court jurisdiction to hear such claims. Section 6214(a) provides the Court with jurisdiction to redetermine a deficiency greater than that set forth in the notice of deficiency, "and to determine whether any additional amount, or any addition to the tax should be assessed, if claim therefor is asserted by the Secretary at or before the hearing or rehearing." On petitioner's theory, such a determination would be impermissible because it would be inconsistent with a supposed prior "determination" by respondent ---- embodied in the notice of deficiency ---- that a smaller deficiency was correct or that the new matter should not be asserted. That is clearly not the law. In this and in other respects, the specific procedures that Congress has ordained for this Court in the Internal Revenue Code may differ from the more general rules embodied in the APA.

The Court notes that there is a penalty imposed on the IRS in this case:

> This is not to say that respondent can delay with impunity in asserting a new matter or an increased deficiency. When respondent does so, our Rules require that the burden of proof be shifted from petitioner to respondent concerning the increased deficiency or new matter. Tax Court Rule 142(a)(1). That, rather than striking respondent's pleading, is the "sanction" imposed by our Rules.

Thus, the Court allowed the IRS to raise this potential for an increased ultimate amount due at trial.

Advisers must always caution taxpayers about not only the costs of pursuing relief by going to the “next level” but also the possibility that the result may end up being worse than what is being protested. In this case (as the Court notes) the taxpayer may still end up being held not liable for the penalty due to other defenses—but the IRS will be granted its day in court on this one.

Section: 6662
Taxpayers with Reasonable Cause for Relying on Valuation Overstatement for 2004 and 2005 Cannot Claim Such Relief for Tax Due on Carryover of Unused Deduction to 2006 Due to Law Change

Citation: Reisner v. Commissioner, TC Memo 2014-230, 11/6/14

The case of *Reisner v. Commissioner*, TC Memo 2014-230 looked at a unique question—could the IRS use a revised version of the penalty rules first applicable to 2006 returns in determining whether a penalty could be waived for reasonable cause when the item giving rise to the penalty was related a carryforward from prior years when different rules applied.

In this case the issue related to the penalty under IRC §6662(h) which imposed a gross valuation misstatement penalty in certain cases. That provisions provides:

> (h) Increase in penalty in case of gross valuation misstatements
>
> (1) In general
>
> > To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".
>
> (2) Gross valuation misstatements
>
> > The term "gross valuation misstatements" means--
> >
> > > (A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting--
> > >
> > > > (i) in paragraph (1)(A), "200 percent" for "150 percent",
> > > >
> > > > (ii) in paragraph (1)(B)(i)--
> > > >
> > > > > (I) "400 percent" for "200 percent", and
> > > > >
> > > > > (II) "25 percent" for "50 percent", and
> > > >
> > > > (iii) in paragraph (1)(B)(ii)--
> > > >
> > > > > (I) "$20,000,000" for "$5,000,000", and
> > > > >
> > > > > (II) "20 percent" for "10 percent".

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "40 percent" for "65 percent".

In this case the taxpayer conceded that that their claim of a deduction for a conservation easement triggered this penalty. Due to the size of the deduction claimed, the taxpayers exceeded their charitable deduction limits for 2004, and the excess carried over to both 2005 and 2006.

The penalties were abated for 2004 and 2005 by the IRS due to the taxpayers demonstrating reasonable cause. For those years, a demonstration of reasonable cause for the understatement pursuant to IRC §6664(c)(1) was sufficient to remove the penalty.

However, in 2006 the Congress amended IRC §6664(c), adding IRC §6664(c)(3) (actually (c)(2) at the time, but later renumbered to (c)(3)) which provided:

> (3) Special rule for certain valuation overstatements
>
> In the case of any underpayment attributable to a substantial or gross valuation overstatement under chapter 1 with respect to charitable deduction property, paragraph (1) shall not apply. The preceding sentence shall not apply to a substantial valuation overstatement under chapter 1 if--
>
> > (A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and
> >
> > (B) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

This revision applied to returns filed after July 25, 2006.

The IRS argued that since the taxpayer's 2006 return was filed after that date, the penalty for 2006 could not be abated based on reasonable cause.

The taxpayers argued that such a result was inconsistent with Congress's intent. They pointed out that changes made at the same time to IRC §170(h)(4) (relating to conservation easements) applied to contributions made on or after July 25, 2006. The Court pointed that Congress did not apply such language in the statute, but rather clearly looked to a return filing date for the reasonable cause exception to the penalty.

As the Court noted, there had been a gross valuation misstatement in the prior years and the taxpayers had escaped the penalty due to the availability of a reasonable cause exception in those years. However for 2006 no such exception exists—thus, the penalty applied.

The Court also rejected the view that this was a "retroactive" penalty. The Court noted that the taxpayers reaffirmed the 2004 valuation when they filed a 2006 return claiming the benefit of that overstated valuation. Having taken that step after the law was changed, they now faced the consequences of claiming that tax benefit.

The taxpayers also pointed that the Court did not address reasonable cause in a similar case (*Pollard v. Commissioner*, T.C. Memo. 2013-38) that involved a contribution in a pre-2006 year and carryover into 2006. The Court noted:

> Our decision in *Pollard v. Commissioner*, T.C. Memo. 2013-38, does not contradict the conclusion we reach here (or our conclusion in Chandler). On brief in Pollard the Commissioner stated he would concede the gross valuation misstatement penalties for 2006 and 2007 if the taxpayer established

> that he satisfied the reasonable cause exception of section 6664(c)(2) for 2003, 2004, and 2005, which he did.

Or, to put it more simply, the Court was never asked to address the issue in *Pollard.* So while, based on the ruling in this case, the IRS could have prevailed and obtained the penalty for 2006 and 2007, it simply failed to ask to have the penalty applied.

Section: 6662
"Editing" Information Provided to Tax Advisers Meant Taxpayer Could Not Claim Reliance on Their Advice

Citation: Brinkley v. Commissioner, TC Memo 2014-227, 10/30/14

Wanting something to be true won't necessarily make it true. And, it turns out, hiring advisers to help you achieve the tax result you want, but then "editing" the information you provide them doesn't allow you to rely on their work or get out of penalties when you are found to owe tax due to reality not comporting with your view of what should have been the reality.

This was the problem in the case of *Brinkley v. Commissioner*, TC Memo 2014-227. The taxpayer in this case was an individual who was working for a technology company start-up and was given stock in the enterprise. As is often true in such entities, the organization went out regularly to obtain new equity funding which served to dilute the interest of existing shareholders.

Mr. Brinkley was not happy with the dilution of his shares, telling the entity that he would not remain in the organization if his interest fell below 3% of the equity. Initially the company issued Mr. Brinkley additional shares that brought him back to 3%, but later rounds of funding ended up diluting his interests yet again.

At this point Google made on offer to purchase the company, an offer which the company wanted to accept. However Mr. Brinkley was upset that because his interest was less than 3% of the equity, he would receive less than 3% of the price Google was paying.

This was a problem, since as part of the acquisition Google wanted Mr. Brinkley to sign an employment agreement and agree to transfer any intellectual property rights that he might have. So initially the company sent Mr. Brinkley an offer to pay him in cash the difference between just over 3% of the price Google was paying for the entire enterprise and the value of the stock he had.

Mr. Brinkley was concerned that this would cause him to be taxed on that amount as ordinary income. His accountant advised him that, yes, that payment would be taxed as ordinary income.

At this point he hired attorneys who attempted to negotiate on his behalf a revised agreement. However while he informed the attorneys he had an equity interest in the enterprise, he failed to inform them that the interest he currently held was far less than 3% of the outstanding interests in the entity (and thus begins his "editing" of information provided to professionals).

Eventually this negotiation resulted in the following letter from the enterprise to Mr. Brinkley:

> Zave then sent to petitioner a final letter agreement dated August 27, 2011 (letter agreement II). Under the heading "Consideration", letter agreement II provided that, following the merger, Zave would pay petitioner as consideration $3,100,000 of the $93,000,000 purchase price offered by Google in exchange for "(i) all of * * * [petitioner's] shares, warrants and options of * * * [Zave stock] and (ii) * * * [petitioner's] execution of a Key Employee Offer Letter and Proprietary Information and Inventions Assignment Agreement with Google as required in the Merger Agreement". Letter agreement II also provided that petitioner would "not be entitled to the Consideration, except for any

> amount you would be entitled to receive in exchange for your shares * * * in the absence of this Agreement, if you do not comply with the terms of the Merger Agreement".
>
> Under the heading "Internal Revenue Code Compliance including I.R.C. § 409A", letter agreement II provided that payment from the merger "will be subject to all adjustments, tax withholdings, if any, and escrow as required in the Merger Agreement. You agree that the Consideration is to be received by you only at the time(s) and to the extent of the definitive agreements to be entered into with Google Inc. in the event of a Google Liquidation Event."

Mr. Brinkley signed this agreement. In that same month he received a copy of the merger agreement, a document he did not share with his advisers. The merger agreement referred to schedules which were not contained in the document he received. Despite being referenced in the agreement he read, Mr. Brinkley did not request copies of those schedules. The schedules referred to the payments to Mr. Brinkley as deferred compensation.

Despite not having all of the agreement, Mr. Brinkley signed a letter consenting to be bound by the merger agreement. The letter contained a clause providing that Mr. Brinkley agreed he had an opportunity to review with his tax advisers the implications of the merger agreement—though Mr. Brinkley did not take advantage of that opportunity. He also entered into an employment agreement with Google at that time.

The Court summarized the final results of this agreement when the merger closed as follows:

> On September 1, 2011, Zave sent a spreadsheet to its payroll company indicating that petitioner was to receive $1,879,779.03 of deferred compensation from the merger closing. The merger closing took place on or around September 2, 2011. The total value of petitioner's stock was determined to be $787,671. As a result of the merger closing, petitioner received $3,027,515 and became an employee of Google. Of the total proceeds of $3,027,515, $360,065 was held in escrow and distributed to petitioner in a later year.

The amount Mr. Brinkley received that was listed as deferred compensation had taxes withheld—and Mr. Brinkley was not happy with that result. He consulted with his tax advisers and legal counsel who suggested filing a lawsuit with regard to the issue. However, Mr. Brinkley decided to pursue the matter through correspondence only.

His attorney wrote a demand letter to the company referencing a letter issued earlier in the negotiations than the one Mr. Brinkley agreed to—because the attorney had never been informed of this second letter.

> The demand letter stated that Zave's failure to comply with petitioner's demand would result in petitioner's filing suit against Zave for breach of contract. Additionally, the demand letter stated that petitioner would challenge the tax treatment of Zave's reporting on his Federal income tax return by providing a detailed explanation as to the egregious and erroneous position taken by Zave. Petitioner never received any response from Zave regarding the demand letter, and he did not file any suit against Zave.

On his return Mr. Brinkley reported the entire proceeds as being from the sale of his stock, thus obtaining long term capital gain treatment. He removed the deferred compensation amount, and the withholdings on that amount, from his W-2. He reported the additional taxes withheld as estimated taxes on his Form 1040, even though he had paid no such estimates.

He included a Form 4852 (Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.) to his return to reflect his revised W-2 amount reported. He also included an attachment to the Form 4852 indicating that $1,879,779.03 of stock compensation wages were actually proceeds from the sale.

In addition to editing material provided to his advisers, Mr. Brinkley also included selective portions of his agreement with his employer. The Court noted:

> Petitioner also included letter agreement II, emphasizing from it in his explanation that: "'the company . . . will pay you (the taxpayer) an aggregate amount (the "consideration") equal to Three Million One Hundred Thousand Dollars ($3,100,000) of the Ninety-Three Million Dollar (93,000,000 [sic]) purchase price offered by Google, as adjusted in the Merger Agreement IN EXCHANGE FOR (I) ALL OF YOUR SHARES, WARRANTS, AND OPTIONS OF THE COMPANY.'" He further explained that Zave's payroll company had misclassified his stock sale by treating the proceeds as ordinary income and that he wanted the excess Federal income tax withheld to be treated as a 2011 estimated tax payment. He concluded by stating that he was including Form 843, Claim for Refund and Request for Abatement, to request a refund of overpaid Medicare taxes.

He did not include his agreement to accept the merger agreement as part of this information provided to the IRS.

The IRS, after looking at this return, concluded that, in fact, the W-2 was correct and assessed tax against Mr. Brinkley, an assessment the taxpayer challenged in the Tax Court.

The Tax Court was not impressed with Mr. Brinkley arguments, nor with his protest that he had sought out advisers that helped him conclude that the amounts were solely for the purchase of his shares.

As the Court noted:

> Petitioner chose to ignore a lot of relevant information. He did not disclose crucial information to his tax advisers, including the merger agreement and the shareholder's consent. He disregarded the $787,671 determined value of his stock, and he disregarded Zave's consistent position that treated the balance of the payments as compensation for services. He apparently did not make himself aware of the merger terms between Zave and Google, which reflected the intent of the two parties that generated petitioner's income in issue—an intent that petitioner would receive both deferred compensation and capital gain income from his execution of the employment and assignment agreement and the sale of his Zave stock. Petitioner testified that these terms were unknown to him, even though as a shareholder he had consented to be bound by them. Failing to explain persuasively why the express terms of the merger should be ignored, petitioner instead relies heavily on his side contract with Zave, letter agreement II, even though it incorporates the merger agreement.

And continues:

> ...[The l]etter agreement II was silent as to a specific amount being paid for the stock. Instead, it provided that to receive the merger-based income from Zave, petitioner had to fulfill two requirements: (i) he had to sell his stock; and (ii) he had to sign the employment and assignment agreement. While petitioner contends that he gave up only one asset of any worth--the Zave stock--Zave obviously considered his employment and assigns to have considerable value with respect to its merger negotiations. And petitioner undermined his own position when he testified that, if he had dissented, then the merger would most likely not have gone through, not because of his stock ownership, but because he had to "sign over all the intellectual property and sign on with Google."

Finally:

> The record strongly suggests that Zave did exactly what it intended. Zave and Google, not petitioner, were the negotiating parties of the merger and agreed to the schedules that listed petitioner as a deferred compensation recipient. When petitioner became aware that Zave, through the merger terms and through its payroll company, treated most of his "consideration" as deferred compensation, he did not attempt to cure Zave's alleged breach either by requiring Zave to reissue a corrected Form W-2 or by pursuing legal recourse against Zave in accordance with the "Governing of Law and Forum" section of letter agreement II.
>
> ...Consequently, petitioner chose to use his Federal income tax return to “undo” Zave’s Federal information return, Form W-2, in an attempt to obtain preferential tax treatment. Yet in his written explanation attached to Form 4852, petitioner included only that part of letter agreement II that referred to the stock sale while omitting the section that referred to the employment and assignment agreement. Thus, petitioner obscured his true tax situation from both his tax advisers and the Internal Revenue Service.
>
> ...In the end, it appears that petitioner made a decision to receive his merger-based income and his position at Google without causing a stir about receiving deferred compensation.

The Court decided that he had failed to pursue obtaining a structure in his favor in order to get his (not so small) payday, and that having given up his claim to “really” own 3% of the enterprise to get the cash, he had to live with that treatment.

As well, he was subject to penalties even though he sought out professional advice. When a taxpayer “edits” the information given to advisers, reliance on their advice is no longer a reasonable attempt to comply with the tax laws. In this case, having kept key information out of the hands of his advisers (that he had signed a form consenting to the merger agreement and its terms, which specifically treated his payment as largely deferred compensation), he gave up the right to claim reliance on their advice.

Section: 6662
Failure to Read CPA's Instruciton Letter Found to be Proof of Lack of Reasonable Cause for Substantial Understatement of Tax

Citation: Singhal v. Commissioner, TC Summary Opinion 2014-102, 10/29/14

A taxpayer’s failure to follow the instructions in letters sent to him by a CPA ended up costing the taxpayer a penalty under §6662(a) in the case of *Singhal v. Commissioner*, TC Summary Opinion 2014-102.

A taxpayer received a K-1 prepared by a CPA he retained for a partnership he and his wife owned. On the Form 1065 there was reported a long-term capital gain of $553,750 from the sale of a patent by the partnership. The K-1s issued to Mr. and Mrs. Singhal reported that total amount of capital gain, along with an ordinary loss from the operation of the business in the partnership.

The CPA sent a letter along with the K-1 that stated the following:

> Enclosed is your 2010 Schedule K-1 (Form 1065) Partner's Share of Income, Deductions, Credits, Etc. from MAN MACHINE INTER-FACE TECHNOLOGIES, LLC. This information reflects the amounts you need to complete your income tax return. The amounts shown are your distributive share of partnership tax items to be reported on your tax return, and may not correspond to actual distributions you have received during the year. This information is included in the Partnership's 2010 Federal Return of Partnership Income that was filed with the Internal Revenue Service.
>
> If you have any questions concerning this information, please contact us immediately.

The taxpayer dutifully reported the passthrough losses, but left the gain off the return.

The IRS noticed this discrepancy and issued an assessment for the unreported tax. That understatement of tax was (not unexpectedly) sufficiently larger to be a substantial understatement as defined by §6662(d)(1)(A)—the amount of the understatement was larger than the greater of $5,000 or 10% of the tax required to be shown on the return.

Being a substantial understatement, the taxpayer could only escape the penalty if the taxpayer could show either:

- The position leading to the understatement had substantial authority *or*
- There was reasonable cause for the understatement and the taxpayer acted in good faith.

The taxpayer claimed he left the gain off because he did not understand that he could pay tax on amounts greater than what he received from the partnership (the total distributions for husband and wife were $86,875.

The taxpayers claimed two different reasons why they should obtain relief:

- They had made a reasonable "mistake of law" in good faith and/or
- They were so distraught due to the illness of their son when preparing their return that they were unable to do so properly.

The court quickly dismissed the first justification—the Court pointed out the CPA's letter explicitly stated that the taxpayers could have to pay tax on amounts that differed from the amounts they had received as distributions. The taxpayer admitted that he hadn't read the letter—and the Court found the failure to read a letter specifically containing instructions from the professional relied upon to prepare the partnership return as failing to show good faith.

The problem is that the taxpayer has a duty to attempt to properly compute his/her tax. A reasonable person attempting to comply with that duty would read the correspondence from the partnership's CPA, something this taxpayer failed to do.

The Court was sympathetic to the issues involving the illness of the party's son—but noted that the taxpayers never explained exactly <u>how</u> that stress had caused them to be unable to properly prepare the return for the year in question.

Key lessons from this case can be found for both taxpayers and CPAs. For the taxpayers, they must understand they have a duty to read the instructions sent to them by a tax professional, and will be held responsible for failure to comply with those instructions if a tax shortfall occurs.

For CPAs the key takeaway is that preparing such documentation serves to insulate the CPA from being the "fall guy" when things go wrong. Some "less than honorable" individuals are known to be "forgetful" about items they are told which are "inconvenient" (such as having to report income in excess of what they received in cash from a partnership). When the IRS comes calling, such individuals may attempt to either throw blame on the CPA to escape penalties (potentially subjecting the CPA to penalties from the IRS) *or* attempt to argue in civil court that the CPA never told them about this issue—and thus the CPA should be responsible for paying the penalty.

Section: 6662
Erroneous Advice Served Obtained from Two CPAs Deemed to Allow Taxpayer to Escape Substantial Understatement Penalty

Citation: English v. Commissioner, TC Summary Opinion 2014-66, 7/11/14

Reasonable reliance on a tax professional can serve to get taxpayers out of the accuracy related penalty of IRC §6662. In the case of *English v. Commissioner,* TC Summary Opinion 2014-66, http://www.ustaxcourt.gov/InOpHistoric/EnglishSummary.Gerber.SUM.WPD.pdf, the taxpayers were able to use what turned out be erroneous advice to escape the penalty (albeit, not the tax) on an assessment.

Cheryl English had been receiving disability payments from Hartford Insurance after she became disabled in 2007 and could no longer work. The policy provided that her benefits would be reduced if she qualified for Social Security disability benefits. While she applied for such benefits in 2007, she did not receive any in 2007, 2008 or 2009.

In 2010 she was finally awarded Social Security benefits of $49,610 for her prior years and thus had to repay Hartford Insurance $48,144. Since the Hartford benefits had been excluded from Cheryl's income when paid as disability benefits, she wondered if she might be able to exclude the Social Security benefits that she had to require to pay back to Hartford Insurance.

To answer that question she consulted two CPAs and they generally advised her that the benefits would not be taxable. The return for the couple was prepared by a CPA who did not include the benefits as taxable income, though the Court did not indicate if this was one of the two CPAs from whom they initially sought advice.

The IRS disagreed with that view, seeing the payment as being simply Social Security benefits and the Tax Court concurred. The Court noted:

> Section 86 provides that a taxpayer's gross income includes up to 85% of Social Security benefits, including disability benefits, received during the taxable year. However, for purposes of that section, taxpayers may reduce Social Security benefits by repayments of other Social Security benefits previously received. Sec. 86(d)(2)(A). A Social Security benefit is defined as "any amount received by the taxpayer by reason of entitlement to--(A) a monthly benefit under title II of the Social Security Act, or (B) a tier 1 railroad retirement benefit." Benefits received from private insurers, such as Hartford, do not satisfy this definition.

As the understatement of tax exceeded 10% of the amount required to be shown on the return and was also greater than $5,000, the threshold for the substantial understatement accuracy related penalty under IRC §6662(b)(2) and (d)(1) was initially triggered.

However, the penalty is not applicable if the taxpayer can show she acted with reasonable cause and in good faith. [IRC §6664(c)(1)]

In this case, the Court noted that the underlying is "curious" stating:

> Congress saw fit to make a certain percentage of Social Security benefits taxable, even if the payments are for a disability. Congress also provided that in circumstances where Social Security benefits had to be repaid, the initial receipt of the benefits would not be taxable. The disparate treatment of private and public disability benefits for tax purposes is curious and somewhat confusing.

Noting that Cheryl looked to two CPAs for advice on the situation and was told the Social Security was not taxable to the extend it was used to repay the tax free disability benefits, the Court had to decide if that was acting in reasonable cause and with good faith. The Court found that it did.

Note that even though the advice was in error, the taxpayer still escaped the penalty due to reliance on the work of a professional. Generally such reliance is deemed to create reasonable cause if the taxpayer can show:

- The taxpayer sought out the advice of a professional whom they reasonably determined (based on the taxpayer's own knowledge and sophistication) was competent to give such advice;

- The taxpayer provided the adviser will all information they believed to be relevant, as well as any information the adviser requested and

- The advisor was not a promoter of the transaction in question (and whose advice therefore cannot be reasonably assumed to be unbiased).

Advisers should be aware that due to the existence of this defense, the director of the Office of Professional Responsibility has commented multiple times that an adviser who prepared the return and then represents the client before the IRS must consider whether an impermissible conflict of interest exists in representing the client if the adviser's own work becomes an issue.

Section: 6662
IRS Outlines Adequate Disclosure for Purposes of §6662 and §6694

Citation: Revenue Procedure 2014-15, 01/23/14

The IRS issued the annual return disclosure revenue procedure applicable for 2013 income tax returns. Revenue Procedure 2014-15 governs adequate disclosure for reducing the understatement of income tax under IRC §6662(d) (substantial understatement of income tax) and §6694(a) (preparer penalties).

Such disclosures are generally required for tax return positions that lack substantial authority, as that term is defined under Reg. §1.6662-4(d)(2). Unless a taxpayer has a letter ruling on the issue, substantial authority can only be established by an analysis of specific authoritative source materials, weighing materials in favor and in opposition to the position. The fact that the return may be unlikely to be examined or that an agent likely would not raise the issue on exam are not issues to be considered.

The exclusive list of acceptable sources are found at Reg. §1.6662-4(d)(3)(iii) and consist of:

> …applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statutes; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

Editorial materials, such as attorney's opinion letter, tax research publications or even this manual, may not be used directly to provide substantial authority. Rather the professional must refer to the source materials the above materials refer to in arriving at the editorial content found in the document.

If a position lacks substantial authority, but there is a reasonable basis for the position, disclosure will avoid the penalties under both §§6662 (applicable to the taxpayer) and 6694 (applicable to the preparer).

The document outlines disclosures made on the return that will be deemed to be adequate to escape the penalty for substantial understatement of tax without having to file a Form 8275 or 8275-R for positions that have, at a minimum, a reasonable basis for the position as defined in Reg. §1.6662-3.


Form 8275
Disclosure Statement
Part I General Information
Part II Detailed Explanation
Part III Information About Pass-Through Entity.


Form 8275-R
Regulation Disclosure Statement
Part I General Information
Part II Detailed Explanation
Part III Information About Pass-Through Entity.

The requirements are listed generally by form and information type, and describe what items will and will not constitute adequate disclosure.

For any item not directly addressed by this procedure, adequate disclosure can only be made by attaching a properly completed Form 8275 or 8275-R, as appropriate, to the tax return.

The document outlines what the IRS expects of taxpayers when filling out tax returns forms to properly disclose items and should be reviewed by all individuals who are involved in the preparation of tax returns.

A failure to adequately disclose the item under this procedure generally means that if a substantial understatement of income exists, the accuracy related penalty under §6662 will apply to the assessment unless the taxpayer can meet the "reasonable cause" relief found at IRC §6664(c). The IRS does not have to show the taxpayer was negligent or otherwise at fault, unlike the treatment for the regular negligence penalty under IRC §6662.

As the Revenue Procedure notes:

> There is a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10 percent of the amount of tax required to be shown on the return for the taxable year or $5,000. Section 6662(d)(1). Section 6662(d)(1)(B) provides a special rule for corporations. A corporation (other than an S corporation or a personal holding company) has a substantial

> understatement of income tax if the amount of the understatement exceeds the lesser of (i) 10 percent of the tax required to be shown on the return for a taxable year (or, if greater, $10,000) or (ii) $10,000,000. An understatement is the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the return reduced by any rebate. Section 6662(d)(2).

Regardless of whether the understatement is substantial, a preparer can subjected to the penalty under IRC §6694 if an understatement of income is found. The penalty is the greater of $1,000 or ½ of the fees related to the position that lead to the understatement.

Section: 6662
No Substantial Authority or Reasonable Basis Found When Facts Distinguishable From Cited Authorities

Citation: Sharp v. Commissioner, TC Memo 2013-290, 12/23/13

Once a taxpayer is found to have understated his/her income on an individual return by the greater of $5,000 or the amount that should have been shown on the return, the taxpayer is subject to a 20% accuracy related penalty under IRC §6662 unless he/she can show one of the following:

- The position in question had substantial authority;
- The taxpayer had a reasonable basis for taking the position and the position was adequately disclosed on the return or
- The taxpayer had reasonable cause for taking the position, generally by relying on the advice of an independent professional.

In the case of *Sharp v. Commissioner*, TC Memo 2013-290, http://www.ustaxcourt.gov/InOpHistoric/SharpMemo.Kroupa.TCM.WPD.pdf the taxpayer failed to convince the Court that she met any of those conditions.

The tax in question arose from a legal award the taxpayer received that she excluded from her income, arguing it represented either an award in the nature of a workers' compensation settlement or compensation for physical injuries, either of which would be excluded from income under IRC §104.

The Court found neither position applied to her case, deciding the facts of her case did not show that either the payments related her workers' compensation claim, nor where they tied to a physical injury.

This is when the issue of the penalty came into view, and the Court's comments in this case are of interest when considering the application of the position standards.

The standards for "substantial authority" and "reasonable basis" are standards based on law and not facts. Arguably a position related to mistaken facts cannot have substantial authority—and the Court seemed to accept this viewpoint in its argument here.

The Court first looked at substantial authority. The taxpayer referred to various authorities both on the issue of the workers' compensation justification and the physical injury justification. However the Court noted:

> Petitioner must analyze and apply the relevant authorities to her circumstances in order to satisfy the substantial authority standard. Id. We previously found that petitioner failed to establish that the $70,000 in settlement proceeds arose from her settling a claim under the IWCA (Iowa Workers Compensation Act) or from her physical injuries or physical sickness. Accordingly, petitioner has not

> shown the relevant authorities support her position because she has not established they apply to her particular facts.

Effectively the Court is stating that once it found her facts did not fit the cases mentioned, she could not longer have substantial authority.

The Court continued down this path in looking at the reasonable basis assertion, holding:

> Petitioner's reasonable basis argument fails for the same reason that her substantial authority argument fails. Petitioner did not establish that the $70,000 in settlement proceeds arose from her settling a claim under the IWCA or from her physical injuries or physical sickness. Therefore, petitioner has not shown the relevant authorities support her position because she has not established they apply to her particular facts

Again, once the court made its factual determination, it effectively decided her legal support became irrelevant.

She had a better shot at her third contention, as she had noted on her return that she was excluding the income based on the advice of her legal counsel. However here she had a key problem—she only had her statements that she relied on counsel for the position.

The Tax Court generally will only allow the "reliance on a professional" defense if the professional gives evidence supporting the fact that he/she was provided with all information requested and that the professional gave the advice in question. As well, the taxpayer generally has to show that he/she took reasonable steps to determine the professional was competent to render this advice and that the professional did not have a vested interest in giving the advice (such as the professional would only be compensated if the taxpayer took the actions that were alleged to give rise to the benefit).

Section: 6662
Refundable Credits Only Reduce Taxes to Zero, But Not Below, For Purposes of Computing Accuracy Related Penalty

Citation: Rand and Klugman v. Commissioner, 141 TC No. 12, 11/18/13

In the case of Rand and Klugman v. Commissioner, 141 TC No. 12, http://www.ustaxcourt.gov/InOpHistoric/RandDiv.Buch.TC.WPD.pdf, the Tax Court had to decide whether the accuracy related penalty under §6662(a) applied, and to what extent, in a case where a taxpayer's tax shown on the return was reduced erroneously by refundable credits. That is because the penalty is imposed on an underpayment of tax, as defined by IRC §6664.

In the case at hand the taxpayers had computed a tax of $144 before refundable credits. This amount was then reduced by $7,471 of refundable credits, resulting in a net refund of $7,327.

The Court found that unlike the issue it had decided in Feller v. Commissioner, 135 TC 497 (2010) regarding withholding credits, the IRS regulations did not address the issue of refundable credits in computing the §6664, most specifically whether there could be a "negative tax" on which to apply the penalty.

Given the lack of IRS interpretation, the Court sought to come to its own conclusions. It found the most reasonable interpretation was that such credits can reduce the tax shown on the return, but not below zero.

The Court made clear that its interpretation did not mean the statute was unambiguous, or that the IRS could not issue contrary regulations that would the ruling. However, the Court also refused to commit to the position that such regulations would overturn the ruling, holding off on that decision until such time as such regulations are issued by the IRS and an actual case comes before the court.

Section: 6672
Franchisee Vice President and Outside Accounting Firm Found Liable for Responsible Person Penalty for Trust Fund Taxes

Citation: Erwin v. United States v. Coggin, et al, United States District Court for the Middle District of North Carolina, 2013 TNT 26-15, 2/1/13 and 2014 TNT 223-14, 11/17/14

The IRS casts a wide net when trust fund taxes for payroll go unpaid and in the case of *Erwin v. United States v. Coggin, et al,* United States District Court for the Middle District of North Carolina, 2013 TNT 26-15 and 2014 TNT 223-14 the outside accountants and a non-owner franchise vice president each ended up being held responsible for the unpaid taxes.

The IRS moved against these even though it had already obtained a finding that one of the owners of the franchise was a responsible person (*Erwin v. United States*, CA4, No. 08-1564, 1/13/10). As should be clear, the IRS has the right (and will) move against multiple parties in an attempt to obtain the funds in question.

The Court in the first decision we will look at in detail, from February of 2013, held that the outside accountants were liable in this case.

Buddy Light Accounting was a company that would perform various accounting services for customers. Those services included in the matter at hand:

- Managing accounts payable
- Handling payroll including
    - Computing payroll tax liabilities for each employee
    - Computing payroll deposits to be made
    - Preparing the Form 941
    - Making payroll tax deposits

The Light brothers ran Buddy Light Accounting and performed the services in question. The Light brothers were given the authority by the client to make the payroll tax deposits via electronic transfer without receiving signatures or authorizations from any other party. The brothers obtained employee information directly from the client's servers and were the first individuals to actually know what the payroll tax deposit due would be each time.

Eventually the company ran short of funds and insufficient funds existed to make a payroll tax deposit. The brothers informed the client that insufficient funds existed to pay employees, vendors and the taxes, including meetings with the client to go over the problem. The Light brothers prepared payment plans and submitted them to the IRS on behalf of the client.

However, the client informed the Light brothers to continue issuing payroll checks and pay other vendors in preference to the IRS. They also received, from time to time, instructions to make payments to the owners that the Light brothers knew would deplete funds so that payroll taxes could not be paid.

Knowing this, the brothers nevertheless complied with the instructions, paying employees, the owners and even taking their own fee of $4,900 each month when it came due.

The Court found that the Light brothers were responsible parties. They had the authority directly to see that payments were made, yet they did not take such actions. Similarly, they continued to make payments to other parties (including their own accounting firm) knowing taxes remained unpaid. So they both had the authority to make payments (thus were responsible parties) and allowed payments to be made to other vendors when the taxes remain unpaid (thus showing willfulness).

What should the Light brothers have done? While the case may suggest that they should have just ignored the client's instructions and made the transfers, that would amount effectively to unauthorized transfers of funds that weren't theirs—not a good result.

No, the problem was continuing to hold that power once they were aware that there were unpaid taxes and that the client was not willing to give payment of those liabilities preference. It also clearly doesn't help when the accountant goes ahead and takes his own fee as one of those paid in preference to the IRS.

At the end of the day, continuing to receive $4,900 per month for a few months ended up costing the Light brothers over $650,000.

But the Court also went on in 2014 to find that the Franchise Vice President, William G. Pinter, was also liable for these taxes as yet another responsible person. Mr. Pinter was brought in to the organization to attempt to straighten out the franchise in question. He had previously risen to the level of Regional Vice President for the franchisor and then created a franchisee that owned and operated 62 restaurants.

In this the Court looked at six factors to determine if this gentleman was a responsible party in this case. These factors were whether Mr. Pinter:

- Served as an officer or director of the company;
- Controlled the company's payroll;
- Determined which creditors to pay and when to pay them;
- Participated in the corporation's day-to-day management;
- Had the ability to hire and fire employees; and
- Possessed the power to write checks.

On the first criteria, the Court noted:

> Although Pintner was not an officer or director of the company, he was a high-ranking employee who worked closely with the owners and officers of GCAD. Pintner testified that he spoke with Erwin on a daily basis regarding restaurant performance and other matters. While this first factor weighs in Pintner's favor, his duties and level of responsibility, as discussed in more detail below, indicate that Pintner was a responsible person for § 6672 purposes.

The Court next moved on to the issue of whether the vice president controlled the entity's payroll. The Court found:

> Pintner argues that he did not control payroll. However, Pintner's own testimony demonstrates the contrary. Pintner had the ability to sign payroll checks and the corresponding tax returns. He sometimes signed the payroll checks by hand, although the majority of the payroll checks were signed via the Light Brothers' use of a signature stamp of Pintner's signature. That Pintner's signature whether signed by hand or by stamp was apparently required on payroll documents illustrates that Pintner was the party with ultimate authority and responsibility for running payroll. Even if the Light Brothers managed the day-to-day aspects of completing payroll, only Pintner's signature, and not the Light Brothers' signatures, could authorize such checks and tax documents. Pintner cannot now claim that he was not responsible for payroll duties simply because he delegated such tasks to others. See *Erwin*, 591 F.3d at 322 (observing that "delegation will not relieve one of responsibility"

(quoting *Purcell v. United States*, 1 F.3d 932, 937 (9th Cir. 1993)); see also *Bowlen v. United States*, 956 F.2d 723, 728 (7th Cir. 1992) ("[D]elegation of the duty to turn over the taxes does not relieve a responsible person from liability."). The control of payroll factor skews toward a finding that Pintner was a responsible person.

Determining which creditors to pay and when was the next factor considered. On this one the Court observed:

> Pintner disputes whether he ever made determinations of which creditors to pay and which to not pay. He asserts that when he first joined GCAD, he was handed an envelope of bills by his predecessor, who informed him that he needed to decide who gets paid. Pintner testified that he then contacted Erwin and Coggin and explained that "I don't do this, okay?" and Erwin and Coggin reassured him that they would take care of it. (Pintner Dep. [Doc. #1611], at 54:1355:2.) However, Pintner does not dispute that he recommended hiring the Light Brothers, that he oversaw them, and that he at a minimum participated in some contract negotiations for vendors. Nor does Pintner dispute that he received and validated invoices and bills before forwarding them on to the Light Brothers. As already noted above, "delegation will not relieve one of responsibility." *Erwin*, 591 F.3d at 322.
>
> intner denies that he ever engaged in prioritizing certain creditors to the disadvantage of others. However, Pintner testified that when he received urgent calls from vendors demanding payment, he would inform the Light Brothers of such demands and that the vendor needed to be paid. Even if Pintner did not explicitly direct the Light Brothers to pay such a vendor before or instead of another vendor, Pintner's actions nonetheless illustrate that he had the ability and authority to make decisions about payments to creditors. In his position as the head of all operations for GCAD, Pintner's instructions to the effect of "these guys need to get paid. They're yelling and screaming. Figure out what to pay them, okay?" were a form of prioritization, and they certainly provided a direction of when to pay creditors. (Pintner Dep. [Doc. #1611], at 55:58.) Pintner also testified to participating in the decision making process with Coggin and Erwin to develop a payment plan for past due bills with LoPresti, GCAD's main grocery vendor. Additionally, when asked whether he ever wrote checks to LoPresti, he responded "Yes, probably." (Id. at 53:1315.) Similarly, when GCAD fell behind on rent payments, Pintner joined Coggin and Erwin in traveling to Orlando, Florida to negotiate with GCAD's commercial lessor. On the whole, even when viewing this evidence in the light most favorable to Pintner, the evidence demonstrates that Pintner made determinations about which creditors to pay and when to pay them. While this factor does not weigh overwhelmingly toward Pintner being responsible, Pintner failed to show he did not effectively prioritize between creditors.

The Court quickly disposed of whether Mr. Pinter participated in the day to day management of the enterprise, finding that it was clear from his position and the facts of the case that he had that level of participation. He also clearly had the ability to hire and fire employees in his position. As well, he had check writing authority and it was not an authority that was not used—even if, in many cases, it was used via a signature stamp he authorized the Light brothers to use.

The Court found the majority of factors held in favor of finding Mr. Pinter was a responsible party. So next the Court looked to whether his actions were willful.

The Court found that he was aware of the deficiency and failed to take action to insure they paid. Although he argued that the owners assured him the payroll tax problem would be taken care of, the Court found that once he was aware of the problem, it was not sufficient for him to accept the assurances of another party when he had the power himself to solve the problem.

As the Court noted:

> From October 1999, until December 1999, Pintner had actual knowledge of the tax deficiencies. As a result, he had a duty to use unencumbered funds to pay the tax deficiencies. Pintner failed to do so, despite having undisputed checkwriting power and authority over incoming bills and invoices.

Section: 6672
Chapter 11 Bankruptcy Did Not Mandate Payment of Other Creditors First, Thus CFO Willfully Failed to Pay Over Trust Fund Taxes

Citation: Nakano v. United States, 113 AFTR 2d 2014-941, CA9, 2/18/14

In the case of *Nakano v. United States*, 113 AFTR 2d 2014-941, http://cdn.ca9.uscourts.gov/datastore/opinions/2014/02/18/11-18013.pdf, the Ninth Circuit clarified that it will follow the analysis of "willfulness" for purposes of the responsible person penalty that was enunciated by the Eighth Circuit in the case of *Honey v. U.S.*, 69 AFTR 2d 92-1333, (CA8, 1992).

The case before the Ninth Circuit was an appeal by a former Senior Vice President and Chief Financial Officer of a failed airline. The airline had failed to pay over trust fund taxes subject to §6672 (in this case federal excise taxes rather than payroll taxes) following its bankruptcy filing.

The CFO did not argue he was not a responsible person, but rather that he did not act "willfully" in failing to pay over taxes. The airline, which never became profitable, filed for Chapter 11 bankruptcy protection in December 2000. Following the September 11, 2001 terrorist attacks Congress passed legislation that extended the time due for airlines to pay over excise taxes for the third quarter for a period that eventually ended on January 15, 2002.

The airline filed a return on that date, but did not transmit any taxes. The airline eventually ceased operations and the bankruptcy was converted to a Chapter 7 proceeding.

The CFO argued that he did not act willfully due to the Chapter 11 bankruptcy filing.

The Ninth Circuit, after noting that it had not ever clearly defined its view of willfulness with regard to encumbered funds, turned to the Eighth Circuit's analysis in the *Honey* case and held:

> The leading case to take this view is *Honey*, 963 F.2d at 1089–90. There, the Eighth Circuit considered in detail what funds are "encumbered" and "unencumbered" in this context. The court examined the text of the statute, the sparse existing precedents, and especially the purpose of § 6672. Id. The court concluded that the purpose of the statute is to ensure that the excise tax is paid and that the statute must be broadly construed to permit the government to reach those who are responsible for the corporation's failure to pay the taxes owed. *Id*. at 1090. The court distilled the applicable rule to the following: "funds are encumbered only where the taxpayer is legally obligated to use the funds for a purpose other than satisfying the preexisting employment tax liability and if that legal obligation is superior to the interest of the IRS in the funds." Id.
>
> Every other circuit to have considered the question agrees with the Eighth Circuit's analysis and definition. See *Bell v. United States*, 355 F.3d 387, 394 [93 AFTR 2d 2004-369]–95 (6th Cir. 2004) (adopting the *Honey* definition); *United States v. Kim* , 111 F.3d 1351, 1359 [79 AFTR 2d 97-2238] (7th Cir. 1997) (same); *Barnett v. Comm'r* , 988 F.2d 1449, 1458 [71 AFTR 2d 93-1614] (5th Cir. 1993) (same). In *Purcell* , we noted a broader rule, offered by the Eastern District of Michigan Bankruptcy Court, that encompassed restrictions on assets imposed by a creditor, beyond those imposed by law. 1 F.3d at 939 (citing *In re Premo*, 116 B.R. 515, 535 [71A AFTR 2d 93-4677] (Bankr. E.D. Mich. 1990)). But the Sixth Circuit has since rejected that rule and has adopted explicitly the Eighth Circuit's narrower definition. *Bell*, 355 F.3d at 395; see also *Huizinga v. United States,* 68

> F.3d 139, 145 [76 AFTR 2d 95-7025] (6th Cir. 1995) (citing approvingly the *Honey* definition). We, too, are persuaded by *Honey* and now adopt the quoted test as our own.

Applying that definition, the Court found that Mr. Nakano faced a legal obligation superior to that of the United States. The panel rejected the taxpayer's argument that the Bankruptcy Code required that precedence be given to operating expenses in a Chapter 11 proceeding, finding instead that "[Bankruptcy Code] [s]ection 503(b)(1)(A)–(B), by its clear terms, mandates equally the payment of operating expenses and taxes. Operating expenses do not gain a higher priority."

Under *Honey* the encumbered funds defense only is applicable if there is a legally superior claim to the funds, not a legally equivalent one. Thus, the Court found that paying the expenses for operations but not paying the IRS was a willful act.

Section: 6694
Email Outlines Procedures for Exam to Use When Statute of Limitations Running Out, the Exam is Not Finished, and the IRS Believes a Preparer Penalty May Apply

Citation: Chief Counsel Email 201425012, 6/20/14

An IRS email (Chief Counsel Email 201425012, http://www.irs.gov/pub/irs-wd/1425012.pdf) deals with how an IRS agent should proceed if an examination of a taxpayer's return takes an extended period of time and there is a concern that assessing a preparer penalty under IRC §§6694(a) and/or 6695 might be appropriate.

The problem is that the statute on the penalty begins to run at the same time and over the same period as the underlying return. Normally the IRS waits for the completion of the examination of the underlying return before investigating the preparer.

First, as a practical matter the details and results of the exam are key factors to be considered in assessing the penalties, since the penalties under §6694 require there be an understatement of tax and the penalty under §6695(g) deals with lack of due diligence in determining if someone was eligible for the earned income credit, so that the final determination if that person was eligible is clearly a useful piece of information.

Second, informing a preparer that he/she is under investigation for a preparer penalty clearly could be seen as an irresponsible attempt at intimidation of the preparer's representation and, perhaps, even looked at as an attempt to extort concessions in the exam.

In fact, the IRM provides that an unagreed penalty case generally may not be sent to Appeals before the related tax return is submitted to Appeals.

But the practical problem remains that if the underlying exam's complexity causes it to approach the statute date, the IRS may lose the ability to pursue a penalty against the preparer unless action is taken. For instance, if the IRS is going to need to request a voluntary extension of the statute from the taxpayer and it is granted, without additional action the ability to pursue the preparer will expire at the date of the original, unextended statute for the return.

The email is a request for advice about what exam should do in such a circumstance.

> If there is a delay initiating a preparer penalty exam because of the length of time needed to complete the exam of the underlying tax return, there are procedures in the IRM to deal with an impending expiring SOL. If the underlying exam is prolonged, the IRM provides specific procedures if there is little time left with respect to the 3 year SOL on the preparer penalty. IRM 20.1.6.19.1(3) provides specific procedures for short statute preparer penalty cases. Specifically, if the statute is about to expire and the preparer does not agree to an extension, the penalty is assessed. The preparer still

> has post-assessment appeal rights in that situation just like an pre-assessment rights matter. Examiners are not to submit preparer penalty cases to Appeals if less than 180 days remains on the SOL when received by Appeals. In such cases, the examiner should seek a consent to extend the SOL. Again, if the SOL is about to expire and no consent to extend can be obtained, the penalty is assessed by Compliance. See IRM 20.1.6.21 and 8.11.3.2(2).

What about that rule that an unagreed tax case can't be sent to Appeals until the tax case is sent to Appeals. Well, the email concludes that the procedures say nothing about the investigation or even, if the preparer refuses to extend the statute, the assessment of a penalty.

The memo notes:

> While there does not appear to be an explicit prohibition on beginning the preparer investigation prior to completion of the exam of the underlying return, it is clear that it cannot be sent forward to Appeals prior to the underlying return matter. However, since the determination of whether the 6694/6695 penalty is applicable is based on the facts and circumstances developed during the underlying exam of the tax return, generally such preparer penalties exam would not begin until that process is complete and the relevant facts determined. However, there does not seem to be a requirement that the actual exam of any potential preparer penalty must not be started prior to the completion of the return exam. To the extent an examination of the return preparer is delayed and there is not sufficient time on the SOL, the IRM procedures mentioned above should be followed when such a short statute of limitations exists.

Section: 6707
Material Adviser Information Reporting Penalty Regulations Finalized

Citation: TD 9686, 7/31/14

The IRS finalized regulations related to disclosures by "material advisers" and related penalties under IRC §6707 for the failure of the adviser to make such disclosures. The regulations, published in TD 9686, http://www.gpo.gov/fdsys/pkg/FR-2014-07-31/pdf/2014-17932.pdf, [new Reg. §301.6707-1] are effective for returns whose due date is after July 31, 2014.

Under §6707 a penalty is imposed on a material adviser who fails to file an information return under IRC §6111 or files an incomplete return, related to a reportable transaction (which includes listed transactions).

The penalty in that case is equal to:

- $50,000 for a reportable transaction (unless the transaction is a listed transaction);
- For a listed transaction, the penalty is equal to the *greater* of
  - $200,000 *or*
  - 50% of the gross income from the transaction derived by the adviser related to aid, assistance or advice provided before the adviser filed a disclosure form related to the transaction

As well, the penalty is increased for an intentional act related to a listed transaction. In that case the penalty is the *greater* of:

- $200,000 *or*
- 75% of gross income

Generally, to be a "material adviser" an individual must directly or indirectly receive gross income in excess of $50,000 for aid, assistance or advice related to the transaction.

Proposed regulations were issued by the IRS in 2008. These regulations adopt those proposed regulations with certain changes.

One key area of change was the addition of a "better late than never" rescission of the penalty provision.

An adviser that files the required Form 8918 ("Material Adviser Disclosure Statement") after its due date will be given credit for a factor weighing heavily in favor of rescinding the penalty as long as:

- The adviser files the form before any taxpayers file a Form 8886 "Reportable Transaction Disclosure Statement" related to the transaction in question *and*
- The adviser files the form before receiving IRS contact regarding the reportable transaction.

The regulations also provide that if the adviser does end up filing the Form after a taxpayer has filed a disclosure form, rescission will not automatically be off the table. Rather, the IRS can still treat that filing as a factor in favor if the agency determines the adviser did not intentionally delay filing until a client had filed a disclosure form.

Conversely, if the IRS determines the adviser did intentionally delay filing (presumably believing no client would file a disclosure) that will eliminate any consideration of the late filed Form 8918 as a factor in favor of rescission of the penalty.

Some other details in the regulations include:

- If there is more than one reportable transaction involved, a separate penalty is triggered for *each* reportable transaction;
- If a transaction is both a reportable and a listed transaction (as any listed transaction would be—a listed transaction is one type of reportable transaction), only the listed transaction penalty applies;
- If there is more than one listed transaction involved, each one is considered separately in computing gross income derived by the adviser
- The omission of immaterial material will not make a return incomplete, though obviously advisers may find the IRS has a different view of immaterial than the adviser
- Intentional non-filing will be determined based on all relevant facts and circumstances related to the advisers' conduct

Section: 6707A
Welfare Benefit Plan Transaction Described in Notice 95-34 Qualifies as Listed Transaction

Citation: Vee's Marketing, Inc. v. United States, (DC WI 10/10/2014) 114 AFTR 2d ¶ 2014-5341, 10/10/14

The taxpayer in *Vee's Marketing, Inc. v. United States*, (DC WI 10/10/2014) 114 AFTR 2d ¶ 2014-5341 had a simple strategy in its case for a claim for a refund of penalties the IRS assessed under §6707A for failing to disclose a listed transaction. The taxpayer's position was simply that the welfare benefit program the taxpayer entered into was not a listed transaction because Notice 95-34 predated the listed transaction.

The taxpayer argued that due to this, the transaction described in Notice 95-34 could not be a listed transaction, which is one identified by the IRS in published guidance. Reg. §1.6011-4(c)(3)(i) provides that the published guidance must meet the following criteria:

- Identify the arrangement at issue as a "tax avoidance transaction" and a "listed transaction" and
- "Describe" the "tax consequences or tax strategy" of the arrangement at issue.

The IRS agrees that Notice 95-34 itself does not identify the welfare benefit plan structure in question as a "listed transaction" or "tax avoidance transaction" as noted in the regulation. However, the IRS points out that Notice 2000-15 specifically lists Notice 95-34 in a list of tax avoidance transactions identified as listed transactions.

The Court did not buy the taxpayer's argument that Notice 95-34 itself had to contain all of the required information. The Court determined that Notice 2000-15 effectively incorporated Notice 95-34's language by reference and the 2000 notice clearly identifies the transaction as a listed transaction.

The taxpayers also point out that the notice did not use the terms "tax strategy" or "tax consequences" and, the theory goes, therefore fails the second test. The Court found that even if those words weren't used, it was clear the Notice was describing a tax strategy and the purported tax consequences.

Thus the Court denied the taxpayer's motion to obtain a summary judgment on this issue—that the transaction described is a listed transaction and the only issue to be decided at trial is whether the transaction the taxpayer participated in is that transaction or one that is substantially similar.

Section: 7122
IRS Outlines Administrative Remedies Upon Termination of Offer in Compromise or Installment Agreement

Citation: Chief Counsel Email 201421018, 5/23/14

An interesting analysis of taxpayer's rights (or lack thereof) when the IRS terminates an offer in compromise is discussed in Chief Counsel Email 201421018 (http://bit.ly/CCE21018).

The email concludes that if the IRS terminates a previously accepted offer in compromise due to the IRS determination of fraud, the taxpayer has no direct administrative remedy. The email does caution, though, that the taxpayer most likely could raise the issue with Appeals in a follow-up Collection Due Process hearing.

The email also points out that the above is not true for an installment agreement where the taxpayer has been granted a right administratively appeal such a termination under IRC §6159(e). As well, the taxpayer could raise the issues in a CDP hearing.

The email also points out that these taxpayers do have some potential options by taking the matter to court. This would include:

- Paying the tax in full and then filing a refund suit arguing that the OIC agreement had conclusively settled the tax liability (of course, the problem most likely will be that the taxpayer can't pay the tax—or if the taxpayer can, it may show the IRS was right about the fraud issue)
- The taxpayer could pursue a damages claim against the IRS for breach of contract
- Finally there may be some options to receive damages under §7433, though the memo concludes the court could not reinstate the agreement under that provision, but only award damages

Section: 7201
Extravagant Spending While Aware of Tax Debt Not Sufficient to Show Willful Attempt to Evade Tax in Bankruptcy

Citation: Hawkins v. Franchise Tax Board, et al, 2014 TNT 179-11, 9/15/14

It's not often that a court opinion begins with quotations from F. Scott Fitzgerald and Ernest Hemingway, but that was the way the Ninth Circuit's opinion *Hawkins v. Franchise Tax Board, et al*, 2014 TNT 179-11. The opinion begins with:

> F.Scott Fitzgerald observed early in his career that the very rich "are different from you and me," to which Ernest Hemingway later rejoined, "Yes, they have more money."

With that opening, the majority of the appellate panel reversed the holding of a lower court that held Mr. Hawkins' continued extravagant spending after being aware of a significant outstanding tax liability represented an attempt to evade or defeat taxes that precluded discharge in bankruptcy under 11 USC §523(a)(1)(C).

The original bankruptcy court and U.S. District Court's findings are summarized in the majority:

> The bankruptcy court found that Hawkins and his wife did very little to alter their lavish lifestyle after it became apparent in 2003 that they were insolvent and that their personal living expenses exceeded their earned income.

However, the majority held that the mere showing of extravagant expenditures does not show there was a level of willfulness to evade tax, a requirement of the statute. Rather the Court found that a specific intent to evade taxes must be found by the Court in order to find the taxes non-dischargeable under 11 USC §523(a)(1)(C).

However, the majority notes that this is not the holding of certain other Circuits. In those Circuits, the majority notes, it is deemed sufficient to show willfulness if it is demonstrated that:

- The debtor had a duty to pay taxes under the law
- The debtor knew he had a duty to pay the taxes and
- The debtor voluntarily and intentionally violated that duty

The Court found that the government's view that if it could should show an intentional act lead to the nonpayment of taxes, even if not shown to be done with the intent to evade taxes, goes beyond the law.

The Court did not hold that this individual will get the taxes discharged—rather that the Court needed to consider whether a showing of intent to evade the tax was shown.

However, one member of the panel disagreed. She wrote:

> I respectfully dissent. I agree with the majority that the rich are different in many ways, but that difference should not include an unfettered ability to dodge taxes with impunity.
>
> There is little doubt, if any, that William Hawkins deliberately decided to spend money extravagantly rather than pay his duly assessed state and federal taxes. Hawkins now seeks to discharge these taxes in bankruptcy.

The dissent specifically referred to a Tenth Circuit decision that followed the reasoning of the bankruptcy court in this case.

> The Tenth Circuit held that the determination of "whether or not a debtor willfully attempted to evade or defeat a tax under 11 U.S.C. § 523(a)(1)(C)is a question of fact reviewable for clear error. . . ." (citation, footnote, reference and alterations omitted). Id. at *6. The court articulated the following elements required to satisfy the mental state requirement: "1) the debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty." Id. (citing *Vaughn v. IRS (In re Vaughn)*, 463 B.R.531,546 (Bankr. D. Colo. 2011); *Hawkins*, 447 B.R. at 300).

Section: 7434
Taxpayer Who Gave Contractor Restrictively Endorse Check in Payment of Disputed Debt Found Liable for Issuing Fraudulent 1099

Citation: Shiner v. Turnoy, 114 AFTR 2d 2014-5179, USDC ED IL, 7/11/14

The case of *Shiner v. Turnoy*, 114 AFTR 2d 2014-5179, http://www.gpo.gov/fdsys/pkg/USCOURTS-ilnd-1_13-cv-05867/pdf/USCOURTS-ilnd-1_13-cv-05867-1.pdf, illustrates a number of interesting factors in the area of taxes, though it arises out of a business dispute between the parties. In the end, though, David Shiner found himself stuck with liability due to fraudulently filing a Form 1099.

David Shiner had agreed to divide certain insurance commissions evenly with Bernard Turnoy. At the end of 2012 David told Bernard that he had received $298,000 in total in commissions. Bernard protested that the actual amount was much higher.

David ignored Bernard's complaints and rather decided to try to put the matter to rest by issuing Bernard a check for $149,000 with a note on the reverse side, where the check would be endorsed, that endorsing the check would constitute a full and absolute release of any additional claims against David by Bernard. He also informed Bernard that the $149,000 would be reported on a Form 1099 to be issued to Bernard.

Bernard did not cash the check but rather filed suit the following day. While Bernard did not immediately return the check, he did not cash it and in August of 2013 eventually returned it.

David in January met with his CPA and told him he had paid Bernard $149,000 for his share of the commissions. He did not inform the CPA about either the dispute or the restrictive endorsement note he had placed on the check. His CPA advised him that he was required to file a Form 1099 for the payment to Bernard for 2012 and David filed the Form 1099.

The Court noted that the general rule is that a creditor cannot escape having constructive receipt of income (and therefore become taxable on it if reporting on the cash basis) by failing to cash a check. The mere receipt of the check is generally considered constructive receipt.

However, the Court found that this is different, presenting the same issue the Tax Court had dealt with in the case of *Bones v. Commissioner*, 4 TC 415 (1944). Where there is a legitimate dispute over the amount of the debt, the placing of a restrictive endorsement on the check gives the creditor the right to reject the payment and, therefore, not be subject to tax based on the receipt of the check.

In this case it was clear that the point of the endorsement was to force Bernard to put his position regarding the right to additional compensation at risk, being sent along with the implied threat that "you'll need to pay tax on this anyway" so that he risked owing tax but not having cash if he did not cave in on the matter. The

Court, not surprising, decided this looked like a bad faith issuance of a Form 1099 and found David liable under IRC §7434(a) for damages for having willfully filed a fraudulent Form 1099.

But David protested that his CPA had told him he had to file the form, so he was just following professional advice. The Court noted that while reliance on a professional might serve as a defense in the proper circumstance, this wasn't it.

The key problem was that David failed to disclose facts to the CPA (specifically the dispute over the amount of the fees and the existence of the restrictive endorsement) when seeking the CPA's advice. Failing to turn over information the individuals either knows or should have known was relevant is fatal to a claim of reasonable reliance on professional advice.

The case illustrates the risks that a taxpayer undertakes when they decide to use a Form 1099 to threaten or punish another party, something that all too often clients who get into disputes want to do. A CPA should be sure to advise a client about the risks under §7434(a) if a Form 1099 is found to be issued in "bad faith" and generally should suggest clients limit the use of such forms to cases where they are required if the taxpayer wishes to avoid having additional (and likely expensive) additional litigation, as well as the risk of owing penalties to the party that they wanted to see "punished" for some bad act.

Section: 7434
Former Employee Not Able to Seek Damages Under §7434 from CPA Firm That Prepared W-2s for Employer

Citation: Swartwout v. Edgewater Grill LLC, et al., 2013-2 U.S.T.C. ¶50,438, 7/12/13

Under IRC §7434(a) an individual may be held liable for damages for willfully filing a fraudulent information return, payable to the person to whom the 1099 or other information return is issued. In the case of Swartwout v. Edgewater Grill LLC, et al., 2013-2 U.S.T.C. ¶50,438, the recipient attempted to include in the claim for damages not only his employer but the CPA firm and managing partner of that firm that prepared the Forms W-2 for his employer.

Mr. Swartwout argued that the CPA firm conspired with his employer to file the false W-2. However, the District Court, citing the decision from the Eastern District of Michigan in the 2013 case of Vandenheede v. Vecchio, No. 12-12284, found that only the person charged with actually issuing the Form W-2 can be held liable for damages under §7434.

The Court found that even if it was accepted that the CPA firm has conspired with the employer to issue a fraudulent W-2, no secondary liability would exist under IRC §7434.

While the result is good news for the CPA firm, it is important to remember that §7434 does exist. This ruling did not resolve the issue of whether, in fact, the employer had issued a W-2 that was fraudulent, being limited only to the question of whether the case could continue against the CPA firm and managing partner.

From time to time CPA firms will find clients that want to use a Form 1099 to "get even" with someone they believe have wronged them, using what may appear to be a tortured theory about the income they believe should be reported by the other party. While the recipient may not have the ability to pursue the CPA firm, if the issuer ends up with paying out damages that client may decide to seek redress from the CPA firm that failed to warn them about this issue.

For that reason, CPA firms do need to counsel clients about the need to limit the issuance of 1099s to cases where the law applies, and not try and use the forms as a device to extract vengeance.

Section: 7502
Stamps.com Log of Printing of Certified Mailing Label Not Sufficient to Invoke Timely Mailing Equals Timely Filing Rule

Citation: Sanchez v. Commissioner, TC Memo 2014-223, 10/22/14

The timely mailing equals timely filing rules have strict requirements that must be met to establish timely filing even though the document is actually delivered after the last date for filing. The rule can easily trip up both taxpayers and advisers, as the taxpayer in the case of *Sanchez v. Commissioner*, TC Memo 2014-223 discovered.

The particular problem is that the rule is not as simple as the "timely mailing equals timely filing" statement would make it appear. In fact, IRC §7502 is a quite a bit longer than the simple statement (which is the way the Tax Court referred to the rule in the case) would make it appear.

The basic rule, found at IRC §7502(a)(1), provides:

> If any return, claim, statement, or other document required to be filed, or any payment required to be made, within a prescribed period or on or before a prescribed date under authority of any provision of the internal revenue laws is, after such period or such date, delivered by United States mail to the agency, officer, or office with which such return, claim, statement, or other document is required to be filed, or to which such payment is required to be made, *the date of the United States postmark* stamped on the cover in which such return, claim, statement, or other document, or payment, is mailed shall be deemed to be the date of delivery or the date of payment, as the case may be.

The key issue to note is that the postmark applied by the United States Postal Service is the actual controlling piece of evidence. So, regardless of when the document is delivered to the U.S. Postal Service, it is the date that the postmark is applied that is key.

Since a taxpayer couldn't be sure of that date, the provision goes on to establish a way to obtain proof of the postmark. IRC §7502(c) provides that a taxpayer may establish the date of filing by using registered mail or, to the extent provided for in regulations, certified mail. In this case the taxpayer was attempting to use the certified mail proof option.

Per the applicable regulations, "[i]f the document or payment is sent by U.S. certified mail and *the sender's receipt is postmarked by the postal employee* to whom the document or payment is presented, the date of the U.S. postmark on the receipt is treated as the postmark date of the document or payment." [Reg. §301.7502-1(c)(2)]

The key issue is that a U.S. Postal Service employee has to be presented the document and the taxpayer must obtain and retain the filing receipt on which the Postal Service employee places the postmark.

In the case in question, the taxpayer used an electronic mailing program from Stamps.com to produce a label with postage to mail his petition to the Tax Court and, as well, pay for the use of certified mail. The Stamps.com electronic stamp that was placed on the envelope contained its own postmark date—but note that this date is not placed on the envelope by the U.S. Postal service, or a postal service employee. As well, although Stamps.com retains information that shows the label was printed on the date on the sticker, that will not be evidence of timely mailing.

In this case the taxpayer gave the return to an assistant who took the document to the post office along with other mail for the day. The assistant found that there were long lines at the post office when she arrived there that day. Thus, rather than taking the documents into the post office itself, she dropped the documents into the mail depository at the Post Office.

The Post Office applied a postmark dated the next day on the envelope and it was sent on to the Tax Court. Unfortunately, the day it had been dropped off at the post office was the last day for the petition to be filed with the Tax Court.

The taxpayer argued that he should be able to the Stamps.com log of when the label was produced, along with the testimony of the assistant, to show that his petition was timely filed.

The Tax Court did not accept this logic. The Court noted:

> As previously stated, the petition was mailed using postage printed through Stamps.com. However, according to the third party who delivered the petition to the post office, the petition was deposited into a mail receptacle with no request that a certified mail receipt be postmarked by a U.S. Postal Service employee. As a result, petitioner is not entitled to any relief under section 301.7502-1(c)(2), Proced. & Admin. Regs. Rather, to paraphrase section 301.7502-1(c)(1)(iii)(A), Proced. & Admin. Regs., quoted above, because the U.S. Postal Service postmark on the envelope does not bear a date on or before March 3, 2014, the petition is considered not timely filed regardless of when the petition was deposited in the mail.

The postmark applied to the envelope by the U.S. Postal Service ends up being the controlling piece of evidence, evidence that could only be overcome by a receipt stamped by a Postal Service employee, something that was not obtained in this case.

This case is instructive for two reasons. First, advisers should note that it is important when they are mailing documents that are date sensitive to the IRS, that the document should be sent via the postal service and that the package must be taken into a post office to obtain that white mailing receipt.

Second, advisers should consider making it clear to clients that if they want the protection of certified mail, they must actually go to the Post Office and stand in line. Using any sort of third party service (postage meter, Stamps.com or a third party mailing service like a UPS Store), even though they may offer certified mailing options, will not be sufficient to prove timely filing.

Section: 7521
Appeals Found in TIGTA Review of Restrictions on Directly Contacting Taxpayer to Have Violated Standards in Over 11% of Cases Reviewed

Citation: TIGTA Audit Report 2013-30-080, 8/30/13

The Treasury Inspector General for Tax Administration found that the IRS has deviated from procedures regarding contacting taxpayer representatives in over 11% of the cases it reviewed in TIGTA Audit Report 2013-30-080 (http://www.treasury.gov/tigta/auditreports/2013reports/201330080fr.pdf). Under IRC §7521 the agency is supposed to contact a taxpayer's representative and provide copies of all correspondence to that person once the taxpayer has granted a power of attorney via Form 2848 to a representative.

TIGTA sampled 96 appellate cases to test for compliance with IRS procedures in this matter. It found violations of the provisions in 11 of those cases.

Most of the violations (9) involved a failure to document that copies of taxapyer's correspondence were sent to the taxpayer's representative. However, in 2 of the cases the agency found an attempt to contact the taxpayer directly by telephone rather than contacting the representative.

Under IRS procedures, such direct contact is limited to informing a taxpayer that a representative is responsible for an "unreasonable delay or hindrance" of the exam, an then only after receiving permission from a superior. TIGTA found no evidence of such lack of cooperation by the representative or existence of supervisor approval in either case uncovered.

The report is troubling on a couple of levels. First, generally appeals should normally be thought to have greater experience and more awareness of such rules than would examination employees, so any departures at this level suggest issues. Second, even though the majority of cases had no such problems, enough did that advisers should be aware of the need to explain the provisions to clients.

That includes suggesting that clients provide the adviser with copies of all correspondence that they receive, just in case the document "falls through the cracks" at the IRS level. As well, clients should be advised to immediately direct any IRS contact or attempted contact to the representative, and to inform the representative if such contact is made.

Section: 7604
Taxpayer's Mere Allegation of Improper IRS Motive Not Sufficient to Allow Questioning of IRS Agents Regarding Reasons for Summons

Citation: United States v. Clarke, 113 AFTR 2d ¶2014-922, 6/19/14

The United States Supreme Court, resolving a split among the Circuit Courts of Appeal, has outlined the standard a taxpayer must meet in order to challenge an IRS summons in the case of *United States v. Clarke*, (113 AFTR 2d ¶2014-922, http://www.supremecourt.gov/opinions/13pdf/13-301_g9m4.pdf).

The Eleventh Circuit, which issued the decision in the case that was brought before the Supreme Court, had taken the position that a single allegation of improper purpose was sufficient to allow the taxpayers to question the IRS regarding the reasons for issuing the summons. As the Supreme Court pointed out, no other Circuit has applied such a low hurdle to opening up an inquiry into the IRS's motives.

A unanimous Court determined that the Eleventh Circuit was in error in applying such a low hurdle.

Rather, Justice Keagan, writing for the Court, outlined the following standard:

> As part of the adversarial process concerning a summons's validity, the taxpayer is entitled to examine an IRS agent when he can point to specific facts or circumstances plausibly raising an inference of bad faith. Naked allegations of improper purpose are not enough: The taxpayer must offer some credible evidence supporting his charge. But circumstantial evidence can suffice to meet that burden; after all, direct evidence of another person's bad faith, at this threshold stage, will rarely if ever be available. And although bare assertion or conjecture is not enough, neither is a fleshed out case demanded: The taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive.

The Court noted that although the taxpayer offered some claims regarding the issue, the Eleventh Circuit did not discuss any of that evidence in arriving at its conclusion. Rather it applied a blanket rule that the Supreme Court rejected. Thus the case was sent back to the Circuit Court for a redetermination.

As well, the opinion outlined the issues that were and were not proper for the Court of Appeals to consider on remand. The opinion noted that the Court of Appeals reviews a District Court's finding of facts only for an abuse of discretion, but has full rights to consider matters of law.

Thus, the Court pointed out (without comment on the proper answer) that the District Court's finding that motives for a summons are tested only when the summons is issued is a legal finding that is not subject to the broad deference granted the findings of fact.

Section: 7263
IRS Letter Claiming Notice Denying Whistleblower Award Was Issued in Error Does Not Serve to Remove Tax Court's Right to Hear Case Regarding the Matter

Citation: Ringo v. Commissioner, 143 TC No. 15, 10/6/14

In the case of *Ringo v. Commissioner*, 143 TC No. 15 the IRS argued that a taxpayer had no right, at least at this time, to have its case for a whistleblower award heard by the United States Tax Court. The IRS based its argument on the fact that even though it had issued a letter stating the taxpayer was ineligible for a whistleblower award, more than seven months later the IRS issued a notice to the taxpayer that the agency was still considering the application.

Under IRC §7623(b)(4) a taxpayer may appeal any determination under the §7623 whistleblower program to the United States Tax Court within 30 days of the determination.

In this case the IRS issued a letter on November 7, 2012 to the taxpayer indicating that he was ineligible for an award based on the Form 211 he filed in February of 2011 (and which he later amended in October of that year). The letter informed the taxpayer that IRS had determined that he not provided the IRS with any information that resulted in the collection of any proceeds.

Thirty days later the taxpayer filed a petition with the Tax Court, asking the Court to review the matter. In June of 2013 the IRS issued a letter to the taxpayer stating the November letter had been sent in error and that the office was still considering his application for an award.

The Tax Court, however, found that the IRS can't pull the rug out from under the Tax Court by saying "oops, we sent the determination in error" in a case like this.

The Court held that jurisdiction is determined based on the facts when the taxpayer asked for the Court to step in. At that point in time there was an IRS determination issued within 30 days of filing, and thus the Court had jurisdiction.

The Court noted that in area of notices of deficiency, numerous cases have held that an IRS concession that a notice of deficiency was erroneous does not mean the Tax Court no longer has jurisdiction over the subject matter. The Court found the same rules should apply to whistleblower cases.

Section: 7623
Final Whistleblower Regulations Issued by IRS

Citation: TD 9687, 8/12/14

The IRS has issued final regulations related to whistleblower awards under IRC §7623 in TD 9687 (https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-18858.pdf). The regulation issued are:

- Reg. § 301.6103(h)(4)-1

- Reg. § 301.7623-1
- Reg. § 301.7623-2
- Reg. § 301.7623-3
- Reg. § 301.7623-4

Generally the final regulations adopt guidance previously found in Notice 2008-4 and portions of the Internal Revenue Manual.

Some changes that were made in the regulations when the IRS moved from the proposed regulations to final regulations include:

- Removing State and local government employees and members of a Federal or State body or commission from the list of ineligible individuals
- The IRS will monitor future tax filings to determine if future payments are increased by changes made due to the information (for instance if the information reduced a net operating loss carryforward).

Taxpayers making a claim file Form 211, shown below:

Form **211** (March 2014)	Department of the Treasury - Internal Revenue Service **Application for Award for Original Information**	OMB Number 1545-0409 Date Claim received Claim number *(completed by IRS)*

1. Name of taxpayer (include aliases) and any related taxpayers who committed the violation
2. Last 4 digits of Taxpayer Identification Number(s) *(e.g., SSN, ITIN, or EIN)*
3. Taxpayer's address, including ZIP code
4. Taxpayer's date of birth or approximate age
5. Name and title and contact information of IRS employee to whom violation was first reported, if known
6. Date violation reported (in number 5), if applicable
7. Did you submit this information to other Federal or State Agencies ☐ Yes ☐ No
8. If yes in number 7, list the Agency Name and date submitted
9. Is this ☐ New submission or ☐ Supplemental submission
   If a supplemental submission, list previously assigned claim number(s)
10. Alleged Violation of Tax Law *(check all that apply)*
    ☐ Income Tax ☐ Employment Tax ☐ Estate & Gift Tax ☐ Tax Exempt Bonds
    ☐ Employee Plans ☐ Governmental Entities ☐ Exempt Organizations ☐ Excise
    ☐ Other (identify)
11. Describe the Alleged Violation. State all pertinent facts to the alleged violation. (Attach a detailed explanation and include all supporting information in your possession and describe the availability and location of any additional supporting information not in your possession.) Explain why you believe the act described constitutes a violation of the tax laws.
12. Describe how you learned about and/or obtained the information that supports this claim. *(Attach sheet if needed)*
13. What date did you acquire this information
14. What is your relationship (current and former) to the alleged noncompliant taxpayer(s)? Check all that apply. *(Attach sheet if needed)*
    ☐ Current Employee ☐ Former Employee ☐ Attorney ☐ CPA
    ☐ Relative/Family Member ☐ Other (describe)
15. Do you still maintain a relationship with the taxpayer ☐ Yes ☐ No
16. If yes to number 15, describe your relationship with the taxpayer
17. Are you involved with any governmental or legal proceeding involving the taxpayer ☐ Yes ☐ No
18. If yes to number 17, Explain in detail. *(Attach sheet if needed)*
19. Describe the amount of tax owed by the taxpayer(s). Provide a summary of the information you have that supports your claim as to the amount owed (i.e. books, ledgers, records, receipts, tax returns, etc). *(Attach sheet if needed)*
20. Fill in Tax Year (TY) and Dollar Amount ($), if known
    TY ____ $ ____ TY ____ $ ____ TY ____ $ ____ TY ____ $ ____ TY ____ $ ____
21. Name of individual claimant
22. Claimant's date of birth *(MMDDYYYY)*
23. Last 4 digits of Claimant's SSN or ITIN
24. Address of claimant, including ZIP code
25. Telephone number *(including area code)*
26. Email address
27. Declaration under Penalty of Perjury I declare that I have examined this application, all accompanying statement and supporting documentation, and, to the best of my knowledge and belief, they are true, correct, and complete

Signature of Claimant Date

Catalog Number 16571S www.irs.gov Form **211** (Rev. 3-2014)

Generally the regulations are effective for claims filed or information provided on or after August 12, 2014.

Section: 7701
IRS Issues Definitions of "Transaction" and "Simliar Rule of Law" for Application of Economic Substance Doctrine

Citation: Notice 2014-58, 10/9/14

In Notice 2014-58 the IRS provides additional guidance regarding the statutory economic substance doctrine under IRC §7701(o). This notice provides guidance on:

- The definition of "transaction" for purposes of applying the codified economic substance doctrine under section 7701(o),
- The meaning of "similar rule of law" as described in the accuracy-related penalty under section 6662(b)(6)
- The availability of the reasonable cause exceptions under sections 6664(c) and (d) and the reasonable basis exception under section 6676 because those exceptions are inapplicable to transactions described in section 6662(b)(6).

IRC §7701(o) was added to the law by the *Health Care and Education Reconciliation Act of 2010*. The law provides that a transaction has economic substance if:

- The transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position; and
- The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

Under IRC §6662(b)(6) a 20% accuracy related penalty is imposed on a transaction that lacks economic substance or when the transaction fails to meet a “similar rule of law”. The reasonable cause and good faith exceptions to the accuracy related penalty do not apply to transactions that lack economic substance. [IRC §6664(c)(2) and (d)(2)]

The notice defines a “transaction” for purposes of IRC §7701(o) to include “all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan.” The notice provides that facts and circumstances (read, the IRS’s judgment) will be used when determine a plans steps are to be aggregated or disaggregated when defining a transaction.

The notice does provide general guidance on how this aggregation/disaggregation test is to be applied:

> Generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the "transaction" includes all of the steps taken together -- an aggregation approach. This means that every step in the series will be considered when analyzing whether the "transaction" as a whole lacks economic substance. However, when a series of steps includes a tax-motivated step that is not necessary to achieve a non-tax objective, an aggregation approach may not be appropriate. In that case, the "transaction" may include only the tax-motivated steps that are not necessary to accomplish the non-tax goals -- a disaggregation approach.

The notice goes on to provide some examples in this matter:

> Whether the economic substance doctrine is relevant and whether a transaction should be disaggregated will be considered on a case-by-case basis, depending on the facts and circumstances of each individual case. For example, if transfers of multiple assets and liabilities

occur and the transfer of a specific asset or assumption of a specific liability was tax-motivated and unnecessary to accomplish a non-tax objective, then the economic substance doctrine may be applied solely to the transfer or assumption of that specific asset or liability. Separable activities may take many forms including, for example, the use of an intermediary employed for tax benefits and whose actions or involvement was unnecessary to accomplish an overarching non-tax objective. These situations are merely examples intended to illustrate the potential application of the disaggregation approach and are not exhaustive or comprehensive.

The notice provides that a "similar rule of law" means a rule or doctrine that disallows benefits under Subtitle A of the Code (the income tax provisions) because:

- The transaction does not change a taxpayer's economic position in a meaningful way (apart from Federal income tax effects); or
- The taxpayer did not have a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

The notice indicates that this would include a disallowance under the judicial "sham transaction" doctrine. The notice also provides that the IRS will not assert a penalty under §6662(b)(6)'s "similar rule of law" provision unless the IRS has also asserted that the statutory economic substance doctrine also supported the adjustment.

The notice is effective for transactions back to the original effective date of §7701(o) and §6662(b)(6) which was March 30, 2010. The notice amplifies the previously issued Notice 2010-62.

Section: 9103
Revenue Agent Not Authorized to Revoke Representative's POA Based on Discovery Attorney Shown as Delinquent Status on State Bar Site

Citation: Chief Counsel Email 201329015, 7/19/13 and 201330035, 7/26/13

In emailed advice (CCA 201329015, http://www.irs.gov/pub/irs-wd/1329015.pdf) counsel warned a Revenue Agent that she could not revoke a power of attorney merely by having discovered that the attorney in question had a status showing as "delinquent" on the state Bar's website. The email warned that the attorney may otherwise be eligible to practice before the IRS in a manner that the agent is not aware of (such as being a member of the bar in another state, a certified public accountant, etc.).

The agent is instructed that if she believes the POA holder is not eligible to practice before the IRS, she should refer the matter to the office of professional responsibility.

It would certainly appear that the agent in this case wanted to "lock out" the taxpayer's representative. A somewhat cynical individual might assume the agent would not have been so diligent in checking the representative's status if the agent did not see the representative as a "problem" to her goals.

It is important to note that the Chief Counsel's office consistently has indicated the agent is not the party to take this step, but must refer any concerns to the OPR who will deal with the matter if appropriate. However, the number of such responses suggests that the IRS is having trouble getting this word out to agents in all cases.

As well, it is important to note that there is a problem if a person who has representation right by state law licensing (CPA or attorney) that continuing to represent a client before the IRS after losing their only such license is a violation of Circular 230 for which action can be taken by the OPR. That's true even if the loss was solely due to paying renewal fees late.

The week following the publication of this email, the tale continued in yet another emailed advice (CCA 201330035, http://www.irs.gov/pub/irs-wd/1330035.pdf) that continued the conversation. The Revenue Agent was advised that she could not advise a taxpayer to terminate a power of attorney and she could not herself revoke the power of attorney even if the taxpayer indicates they no longer want the representative to act on their behalf.

Rather, the agent is directed if the taxpayer makes that request to direct them to the instructions to Form 2848 and the portion that deals with how the taxpayer may revoke the power of attorney.

Some more information also was issued related to why the agent wished to remove the POA holder. The memo goes on to discuss the procedures where a POA may be bypassed if the POA holder is nonresponsive, indicating that if the situation does not improve the agent should consider a referral of the POA holder to the OPR. But, again, the agent cannot revoke the POA holder's authority.