RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION
AFFECTING LOW-INCOME TAXPAYERS

“Recent developments are just like ancient history, except they happened less long ago.”

By

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

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I. ACCOUNTING

A. Accounting Methods

1. It doesn’t have to be a valid method of accounting to be a method of accounting a change of which requires the IRS’s consent. Nebeker v. Commissioner, T.C. Memo. 2016-155 (8/16/16). The taxpayer operated a cash method sole proprietorship that began in 1995. He included payments made by clients in the year payment was received but from 2004 through 2009 deducted the expenses associated with generating that revenue in the year payment was received even if the expenses had been incurred in a prior year. The Tax Court (Judge Goeke) held that the taxpayer’s method of deferring deductions was erroneous for a cash method taxpayer, see Reg. § 1.466-1(c)(1)(iv)(a), but it nevertheless was a method of accounting that he consistently used. Thus, the IRS’s adjustment to that item for tax years 2006 and 2009 constituted a change in his accounting method, which, because the IRS’s consent was not secured under § 446(e), triggered the application of § 481.

B. Inventories

C. Installment Method

1. Can an installment sale between related parties ever not have the proscribed tax avoidance purpose requisite for denying installment reporting? Vest v. Commissioner, T.C. Memo. 2016-187 (10/6/16). The taxpayers owned 85 percent of Truebeginnings, LLC, which was an accrual basis partnership for federal tax purposes. According to the reported opinion, Truebeginnings in turn owned 100 percent interests in two other partnerships, H.D. Vest Advanced Systems, LLC (VAS), and Metric, LLC (Metric). (We do not understand how a 100 percent owned LLC can be a partnership rather than a disregarded entity or a corporation, but the opinion says they were partnerships and the issue could not have arisen if they were disregarded entities.) In consideration of 10-year promissory notes, Truebeginnings sold computer equipment to VAS and Metric and sold zero-basis intangible assets with an appraised value of $2,885,175 to VAS. Truebeginnings reported over $3 million of gain on the § 453 installment method. The Tax Court (Judge Lauber) upheld the IRS’s conclusion that the sales did not qualify for installment sale treatment pursuant to § 453(g)(1), which disallows installment reporting for installment sales of depreciable property between related persons unless “it is established to the satisfaction of the Secretary that the disposition did not have as one of its principal purposes the avoidance of Federal income tax.” I.R.C. § 453(g)(2). TB, VAS, and Metric were clearly “related persons,” and the computer equipment and intangible assets that TB sold to VAS and Metric were “depreciable property.” The taxpayer failed to carry the burden of proof that tax avoidance “was not among the principal purposes of the asset sale transaction.” Judge Lauber reasoned that § 453(g)(2) “resembles other Code sections providing that certain tax treatment will be available only if the taxpayer establishes that the plan or transaction did not have ‘as one of its principal purposes the avoidance of Federal income tax,’ and that” Tax Court precedent establishes that “a taxpayer in such cases can satisfy his burden of proof only by submitting ‘evidence [that] clearly negate[s] an income-tax-avoidance plan.’” Tecumseh Corrugated Box Co. v. Commissioner, 94 T.C. 360, 381-382 (1990) (addressing § 453(e)(7)), aff’d, 932 F.2d 526 (6th Cir. 1991). The taxpayer’s burden in such cases is “a heavy one.” Pescosolido v. Commissioner, 91 T.C. 52, 56 (1988) (addressing § 306(b)(4)), aff’d, 883 F.2d 187 (1st Cir. 1989). In ascertaining the true purpose of the transaction, Judge Lauber stated, the Tax Court accords “more weight to objective facts than to the taxpayer’s ‘mere denial of tax motivation.’” The enhanced depreciation deductions available to the related buyer is relevant in deciding whether the seller had a principal purpose of avoiding tax. Guenther v. Commissioner, T.C. Memo. 1995-280. In this case, the court stated, “[t]he substance of the transaction at issue clearly reveals a principal purpose of tax avoidance.”

Notwithstanding the asset sale, petitioner through TB retained full control over the ad-optimization business. By use of installment reporting, TB aimed to defer for 10 years virtually all the tax on its $3.2 million gain, while VAS and Metric
would receive stepped-up bases in, and be able to claim correspondingly large depreciation or amortization deductions on, the assets transferred. This tax-avoidance purpose is particularly clear with respect to the intangible assets sold to VAS. Those assets had a zero cost basis in TB’s hands, thus yielding zero amortization deductions to it. But VAS claimed a stepped-up basis in those assets of $2,885,175, yielding amortization deductions of $192,345 annually. The enhanced amortization deductions claimed by VAS and Metric, totaling $644,772 for 2008-2010 alone, dwarf the $29,798 gain that TB reported for 2008.

D. Year of Inclusion or Deduction

1. The duty of consistency required the taxpayer to include in income for 2009 gross receipts properly reportable in 2008. Squeri v. Commissioner, T.C. Memo. 2016-116 (6/15/16). In four consolidated cases, the taxpayers were shareholders of a cash-basis subchapter S corporation. The S corporation determined the gross receipts that it reported on Form 1120S using the deposits made into its bank accounts during the calendar year. For example, it determined its gross receipts for 2010 with reference to amounts deposited in its bank account in 2010, even though some of the checks deposited in January 2010 had been received in 2009, and even though some checks received in late 2010 were not deposited until January 2011. The IRS issued a notice of deficiency in which it determined that the S corporation had improperly computed its gross receipts. For the years 2010 and 2011, the IRS adjusted the gross receipts by excluding deposited amounts that had been received in the prior year and including amounts that had been received during the year but deposited in the following year. For example, the IRS reduced 2010 gross receipts by excluding amounts deposited in January 2010 that had been received in 2009, and increased 2010 gross receipts by including amounts that had been received in 2010 but deposited in January 2011. However, for 2009, the IRS did not make any adjustments. The taxpayers argued that 2009 gross receipts should be reduced by amounts deposited in January 2009 that had been received in 2008. The year 2008 was not before the court and the period of limitations on assessment for 2008 had expired. The Tax Court (Judge Kerrigan) held that, although the gross receipts received in 2008 and deposited in 2009 were properly reportable as gross receipts for 2008, the duty of consistency required the taxpayer to report the gross receipts in 2009. The duty of consistency is an equitable doctrine that prevents a taxpayer from benefiting in a later year from an error or omission in an earlier year that cannot be corrected because the limitations period for the earlier year has expired. As applied by the U.S. Court of Appeals for the Ninth Circuit, to which this decision is appealable, the duty of consistency has three elements: (1) a representation or report by the taxpayer, (2) reliance by the IRS, and (3) 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 IRS. These elements, the court held, were satisfied by the taxpayer’s filing of Form 1120S reporting the gross receipts for 2009, the IRS’s acceptance of the 2008 return that did not reflect the gross receipts, and the expiration of the period of limitations on assessment for 2008.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Transparent insolvency for disregarded entities, and a push by the IRS to encourage partners to file for bankruptcy along with their partnership. T.D. 9771, Guidance under Section 108(a) Concerning the Exclusion of Section 61(a)(12) Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity, 81 F.R. 37504 (6/10/16). The Treasury Department and IRS have finalized Reg. § 1.108-9, proposed in REG-154159-09, Guidance Under Section 108(a) Concerning the Exclusion of Section 61(a)(12) Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity, 76 F.R. 20593 (4/13/11). Reg. § 1.108-9(a) provides that, for purposes of applying § 108(a)(1)(A) and (B), the bankruptcy and insolvency exclusions, to discharge of indebtedness income of a grantor trust or a disregarded entity, the term “taxpayer,” as used in § 108(a)(1) and (d)(1) through (3), refers to the owner(s) of the grantor trust or disregarded entity. Reg. § 1.108-9(a)(2), which was not in the proposed regulations, but which was added in the final regulations, specifically provides that the
bankruptcy and insolvency exclusions (I.R.C. § 108(a)(1)(A) and (B)) are applied at the partner and not the partnership level, and Reg. § 1.108-9(c)(4), through a cross reference to 11 U.S.C. § 101(13), provides that “The term ‘debtor’ means person or municipality concerning which a case under this title has been commenced.” Thus, the owner of the grantor trust or disregarded entity must itself be under the jurisdiction of the court in a title 11 case as the title 11 debtor to qualify for the bankruptcy exclusion.

- The preamble emphasizes the IRS’s nonacquiescence, AOD 2015-01, in the Gracia Cases (Gracia v. Commissioner, T.C. Memo. 2004-147; Mirarchi v. Commissioner, T.C. Memo. 2004-148; Price v. Commissioner, T.C. Memo. 2004-149; Estate of Martinez v. Commissioner, T.C. Memo. 2004-150 (collectively)) in which the Tax Court held that partners who as a result of being general partners were under the jurisdiction of a bankruptcy court as part of the proceedings regarding the partnership, but who were not debtors, could take advantage of the bankruptcy exclusion in §108(a)(1)(A). Together Reg. § 1.108-9(a)(2) and (c)(4) prevent a partner who was not a debtor in bankruptcy in his individual capacity to claim an exclusion for his shares of the partnership COD income under § 108(a)(1)(A).

- Even though the issue is not addressed in the regulations, the preamble states that Treasury and the IRS “are of the view that indebtedness of a grantor trust or a disregarded entity is indebtedness of the owner for purposes of section 108(d)(1); assuming the owner has not guaranteed the indebtedness and is not otherwise liable for the indebtedness under applicable law, such indebtedness should generally be treated as nonrecourse indebtedness for purposes of applying the section 108(a)(1)(B) insolvency exclusion.” The principles of Rev. Rul. 92-53, 1992-2 C.B. 48 apply to determine the extent to which the debt is taken into account in determining the owner’s insolvency under § 108(d)(3).

**B. Deductible Expenses versus Capitalization**

1. The long reach of the uniform capitalization rules. Wasco Real Properties I, LLC v. Commissioner, T.C. Memo. 2016-224 (12/13/16). The Tax Court (Judge Buch) held that real estate taxes on land on which commercial almond trees were planted were subject to capitalization as indirect costs under § 263A:

   Although WRP I deducted its property taxes, those taxes directly benefit the growing of the almond trees and are allocable to the produced property (the almond trees) that will produce income in the future. Allowing a current deduction of the property taxes would distort WRP I’s actual income for the subject years and would otherwise allow WRP I to offset its unrelated income. This is precisely the mismatch of expenses and revenues that section 263A was enacted to prevent.

   In addition, interest on a loan to acquire the land on which the commercial almond trees were planted was subject to capitalization under § 263A(f). “The land does not have to be the property that is being produced to bring interest on a financing of the land within the reach of section 263A. Rather, pursuant to the command of section 263A(f)(2)(A)(i), the interest that the entities paid on their financing of their land must be capitalized as a cost of their almond trees if the cost of the land is a production expenditure with respect to the almond trees.” Capitalized interest is added to the basis of the almond trees, not the land.

**C. Reasonable Compensation**

1. Shareholder-employees apparently can rake off economic rents as reasonable comp. H. W. Johnson, Inc. v. Commissioner, T.C. Memo. 2016-95 (5/11/16). In this reasonable compensation case, the IRS, among other arguments, advanced the proposition that because the corporation’s return on equity, after deducting compensation paid to the two shareholder-employees, fell below the industry averages in the years in question, the two shareholder-employees were unreasonably compensated in those years. According to the IRS, an independent investor would have demanded a return more commensurate with the corporation’s superior performance. The Tax Court (Judge Gale) agreed with the taxpayer’s argument that its return on equity was in line with the industry average and therefore would have satisfied an independent investor. The IRS cited no authority for the proposition that the required return on
equity for purposes of the independent investor test must significantly exceed the industry average when the subject company has been especially successful, and the court found none in the case law. The IRS conceded that the two shareholder-employees “were absolutely integral to petitioner’s successful performance, a performance that included remarkable growth in revenues, assets, and gross profit margins during those years.” The Tax Court concluded that in applying the independent investor test courts have typically found that a return on equity of at least 10 percent tends to indicate that an independent investor would be satisfied and thus payment of compensation that leaves that rate of return for the investor is reasonable. That standard was met on the facts of this case. The IRS effectively conceded the other four factors of Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983)—(1) the employee’s role in the company; (2) a comparison of compensation paid by similar companies for similar services; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) the internal consistency of compensation arrangements—which controlled because an appeal would lie to the Ninth Circuit. In analyzing the fourth factor, the Ninth Circuit emphasizes evaluating the reasonableness of compensation payments from the perspective of a hypothetical independent investor, focusing on whether the investor would receive a reasonable return on equity after payment of the compensation. Accordingly, the Tax Court allowed the deduction.

D. Miscellaneous Deductions

1. Would Ralph Lauren agree that his clothing is suitable for “general wear”? Barnes v. Commissioner, T.C. Memo. 2016-79 (4/27/16). The taxpayer worked as a salesman for Ralph Lauren Corp., which required all employees who worked in corporate sales positions to wear Ralph Lauren apparel while representing the company. The taxpayer purchased Ralph Lauren shirts, pants, ties, and suits, the costs of which he deducted as unreimbursed employee expenses on Schedule A. The cost of clothing is deductible as a business expense only if it meets the following three-part test: (1) the clothing is required or essential in the taxpayer’s employment; (2) the clothing is not suitable for general or personal wear; and (3) the clothing is not so worn. Hynes v. Commissioner, 74 T.C. 1266 (1980); see also Pevsner v. Commissioner, 628 F.2d 467 (5th Cir. 1980). The Tax Court (Judge Paris) held that the taxpayer could not deduct the cost of his clothing because, although he was required by his employer to wear it, the clothing was suitable for general or personal wear.

2. Is the Tax Court backing off on Altera? Santos v. Commissioner, T.C. Memo. 2016-100 (5/17/16). The Tax Court (Judge Morrison) held pursuant to Reg. § 1.162-5(b) that an accountant could not deduct law school tuition; it qualified him for a new trade or business. The taxpayer argued that court should reconsider its decision in Weiszmann v. Commissioner, 52 T.C. 1106 (1969), aff’d, 443 F2d 29 (9th Cir. 1971), upholding the validity of Reg. § 1.162-5(b), in light of Altera Corp. & Subs. v. Commissioner, 145 T.C. 91 (2015), which, relying on Motor Vehicle Mfrs. Ass’n of U.S. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983), held that a regulation under § 482 was invalid because, in promulgating the regulation, the Treasury did not “adequately respond to commentators.” The court declined to reexamine the validity of the regulation. Altera is distinguishable. Altera held that the validity of the regulation in the particular circumstances of that case hinged on an “empirical determination” and “in no way depends on *** [Treasury's] interpretation of section 482 or any other statute.” Altera Corp. & Subs. v. Commissioner, 145 T.C. at __ (slip op. at 46). By contrast, the education-expenses regulation is an interpretation of sections 162 and 262. See Taubman v. Commissioner, 60 T.C. at 817. Second, Santos did not raise his theories that the regulation was invalid until after trial. As a result, neither the trial record nor the court papers in this case contain any information regarding the public’s comments to the regulation in question. Without knowing what the public comments were, it seems difficult, if not impossible, for the Court to evaluate the adequacy of the Treasury Department’s response to the public comments when it promulgated section 1.162-5, Income Tax Regs.

• Is this an invitation for FOIA requests for comments on
regulations issued nearly 50 years ago? What if there are none? There was no preamble either for T.D. 6291, 1958-1 C.B. 63 (4/3/58), promulgating Reg. § 1.162-5, or for the proposed regulations, 21 F.R. 5091 (6/10/56), but the publication of the proposed regulation states, “Prior to the final adoption of such regulations, consideration will be given to any data, views, or arguments pertaining thereto which are submitted in writing ....”

3. **Standard mileage rates for 2017.** Notice 2016-79, 2016-52 I.R.B. 918 (12/13/16). The standard mileage rate for business miles in 2017 goes down to 53.5 cents per mile (from 54 cents in 2016) and the medical/moving rate goes down to 17 cents per mile (from 19 cents in 2016). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation is 25 cents per mile for 2017 (increased from 24 cents in 2016).

**E. Depreciation & Amortization**

1. **Perhaps he should have played an antique violin.** Kilpatrick v. Commissioner, T.C. Memo. 2016-166 (8/29/16). The taxpayer, a CPA, claimed deductions, as “office expenses” or “supplies” for the cost of certain antiques—oak armchairs, a desk, a number of paintings, two soup tureens, a chandelier, a lamp, a clock—used in his home office, which the IRS conceded qualified for business deductions under § 280A. He did not elect on his return to deduct the cost under § 179. The Tax Court (Judge Morrison) held that the costs were not § 162 ordinary and necessary business expenses but rather were capital expenditures. Furthermore, the taxpayer was not allowed to take depreciation deductions with respect to the antiques. A depreciation deduction under § 167 is not allowable “‘for an asset the value of which is not reduced by the passage of time or by use’” (quoting Hawkins v. Commissioner, 713 F.2d 347 (8th Cir. 1983)), and while some antiques might lose their value through use or through the passage of time, the taxpayer failed to prove that his antiques would do so. The court therefore held that his furnishings would retain their value.


   **2017 Passenger Automobiles with § 168(k) first year recovery:**
   
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</table>
F. Credits
G. Natural Resources Deductions & Credits
H. Loss Transactions, Bad Debts, and NOLs
I. At-Risk and Passive Activity Losses

1. The statute and regulations clearly said to the taxpayer, “you lose,” but she took it all the way to the Ninth Circuit anyway. Gragg v. United States, 831 F.3d 1189 (9th Cir. 8/4/16). In an opinion by Judge Christen, the Ninth Circuit held that although a taxpayer who qualifies as a real estate professional under § 469(c)(7) is not subject to the § 469(c)(2) per se rule that rental losses are passive, the taxpayer nevertheless must materially participate in real estate rental activities in order to deduct rental losses against nonpassive income. Because the taxpayer, who did qualify as a real estate professional, did not materially participate in the rental activity, the losses were disallowed. Based on the statutory language and Reg. § 1.469-9(e)(1), the court rejected the taxpayer’s argument that, by virtue of her status as a real estate professional, the rental losses were automatically nonpassive and she did not need to prove material participation.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Another case illustrating that you really need to stop developing the property in order to claim successfully that the property is not held primarily for sale to customers. Boree v. Commissioner, 837 F.3d 1093 (11th Cir. 9/12/16), aff’g T.C. Memo. 2014-85 (5/12/14). The taxpayers, a married couple, held land through a limited liability company, Glen Forest, LLC. (The LLC had been formed by the husband, Gregory Boree, a former logger, and another individual, but the other individual later sold his interest to Mr. Boree, after which Mr. Boree and his wife were the sole members of the LLC.) The LLC acquired 1,892 acres of vacant real property in Baker County, Florida. In early 2003, the LLC submitted a proposal with respect to the property to the Baker County Planning and Zoning Department for a planned residential development that would consist of more than one hundred 10-acre lots, to be developed and sold in multiple consecutive phases. From 2003 through 2004, the LLC engaged in various development-related activities, such as seeking exemptions from certain requirements, forming a homeowners’ association and providing for representation of the LLC on the association’s board, obtaining county approval of the first three phases of development of the community, applying for an environmental resource permit, and constructing an unpaved road on the property. The LLC sold 15 lots in 2003, 26 lots in 2004, 8 lots in 2005, and none in 2006. From late 2004 through early 2005, the Baker County Board of Commissioners adopted a series of land-use restrictions that affected the LLC’s development, including a moratorium on development and a requirement that all roads within subdivisions be paved. To comply with the paving requirement would have cost the LLC approximately $7 million. To make development more economical, Mr. Boree developed and submitted for approval a higher-density development plan featuring residential, commercial and recreational areas, but following the county’s adoption in 2006 of a requirement that developers pave certain roads leading to developments, the Borees sold the remaining lots to a developer and realized a gain of approximately $8.5 million. The taxpayers reported their gain as long-term capital gain. In an opinion by U.S. District Judge Coogler (sitting by designation), the Eleventh Circuit affirmed the conclusion of the Tax Court (Judge Foley) that the taxpayers’ gain was ordinary income. In reaching this conclusion, the Eleventh Circuit rejected the taxpayers’ argument that their purpose in holding the property had changed when the land use restrictions adopted by the county in 2005 and 2006 made development of the property prohibitively expensive, and that the Tax Court therefore had erred in considering their purpose in holding the property during periods of time prior to its sale in 2007. Considering the taxpayer’s purpose in holding property in the years leading up to its sale, the court reasoned, is consistent with prior decisions of the Fifth and Eleventh Circuits, including Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980) and Sanders v. United States, 740 F.2d 886 (11th Cir. 1984). Further, the court concluded, the
taxpayers’ attempts to respond to the land use restrictions by proposing a higher density development and taking other actions are “evidence of strategic and thorough involvement in pursuit of developing the property [that] indicates that the Borees were holding the property for sale in the ordinary course of business right up until they sold it.” The court similarly rejected other arguments raised by the taxpayer.

• Although it affirmed the Tax Court’s conclusion that the taxpayers held the property primarily for sale to customers, the Eleventh Circuit reversed the Tax Court’s imposition of a 20 percent accuracy-related penalty for substantial understatement of income tax under § 6662(b)(2). The Eleventh Circuit concluded that the taxpayers had successfully established a reasonable cause, good faith defense to the penalty by relying on their accountant, whom the court described as someone who enjoyed a good reputation in the community, in part because he served “as a tax professor at the University of Florida Levin College of Law.”

B. Interest, Dividends, and Other Current Income
C. Profit-Seeking Individual Deductions
D. Section 121
E. Section 1031
F. Section 1033
G. Section 1035
H. Miscellaneous

IV. COMPENSATION ISSUES
A. Fringe Benefits

1. The IRS provides guidance on the application of the Affordable Care Act’s market reforms to HRAs, EPPs, FSAs, and EAPs — it’s the bee’s knees! Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13), supplemented by Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). The Patient Protection and Affordable Care Act amended the Public Health Service Act to implement certain market reforms for group health plans, including requirements that:

   (1) group health plans not establish any annual limit on the dollar amount of benefits for any individual, and
   (2) non-grandfathered group health plans provide certain preventive services without imposing any cost-sharing requirements for the services. The notice provides guidance, in Q&A format, on the application of these market reforms to: (1) health reimbursement arrangements (including HRAs integrated with group health plans), (2) group health plans under which employers reimburse employees for premium expenses incurred for an individual health insurance policy (referred to in the notice as “employer payment plans”), and (3) health flexible spending arrangements. The notice also provides guidance on employee assistance programs and on § 125(f)(3), which generally provides that a qualified health plan offered through a health insurance exchange established under the Affordable Care Act is not a qualified benefit that can be offered through a cafeteria plan. The notice applies for plan years beginning on and after 1/1/14, but taxpayers can apply the guidance provided in the notice for all prior periods. The Department of Labor has issued guidance in substantially identical form (Technical Release 2013-03) and the Department of Health and Human Services is issuing guidance indicating that it concurs.

   a. The obvious solution has a great big catch in it. In a Q&A issued on 5/13/14, available on the IRS’s web site (https://perma.cc/FK5A-FRF2), the IRS states:

   Q1. What are the consequences to the employer if the employer does not establish a health insurance plan for its own employees, but reimburses those employees for premiums they pay for health insurance (either through a qualified health plan in the Marketplace or outside the Marketplace)?

   [A1]. Under IRS Notice 2013-54, such arrangements are described as employer payment plans. An employer payment plan, as the term is used in this notice, generally does not include an arrangement under which an employee may have an after-tax amount applied toward health coverage or take that amount in cash compensation. As explained in Notice 2013-54, these employer payment plans are
considered to be group health plans subject to the market reforms, including the prohibition on annual limits for essential health benefits and the requirement to provide certain preventive care without cost sharing. Notice 2013-54 clarifies that such arrangements cannot be integrated with individual policies to satisfy the market reforms. Consequently, such an arrangement fails to satisfy the market reforms and may be subject to a $100/day excise tax per applicable employee (which is $36,500 per year, per employee) under section 4980D of the Internal Revenue Code.

b. Good news (?) for some employers: the IRS reiterates prior guidance and clarifies issues related to employer payment plans and provides transition relief from the § 4980D excise tax. Notice 2015-17, 2015-14 I.R.B. 845 (2/18/15). This notice reiterates the conclusion in prior guidance, including Notice 2013-54, 2013-40 I.R.B. 287, that employer payment plans are group health plans that will fail to comply with the market reforms that apply to group health plans under the Affordable Care Act. The notice provides guidance, in Q&A format, on several issues, including the treatment of: (1) an S corporation’s payment or reimbursement of premiums for individual health insurance coverage covering a 2-percent shareholder, (2) an employer’s reimbursement of an employee’s Medicare premiums or payment of medical expenses for employees covered by TRICARE, (3) an employer’s increase of an employee’s compensation to assist with payments for individual coverage, and (4) an employer’s provision of premium assistance on an after-tax basis. The notice also provides a transition rule under which the IRS will not assert the excise tax imposed by § 4980D for any failure to satisfy the market reforms by employer payment plans that pay, or reimburse employees for individual health policy premiums or Medicare part B or Part D premiums: (1) for 2014 for employers that are not applicable large employers for 2014, and (2) for 1/1/15 through 6/30/15 for employers that are not applicable large employers for 2015. Generally, applicable large employers are those that employed an average of at least 50 full-time employees on business days during the preceding calendar year. Employers eligible for this transition rule are not required to file Form 8928 (Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code) solely as a result of having employer payment plans for the period for which the employer is eligible for the relief.

c. Final regulations provide guidance on many issues under the Affordable Care Act and incorporate prior guidance issued in forms other than regulations. T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The Treasury Department and the IRS have issued final regulations regarding grandfathered health plans, preexisting condition exclusions, lifetime and annual dollar limits on benefits, rescissions, coverage of dependent children to age 26, internal claims and appeal and external review processes, and patient protections under the Affordable Care Act. Among many other changes, the final regulations provide guidance on integration of health reimbursement arrangements with other group health plan coverage and modify Notice 2015-17 by providing a special rule for employers with fewer than 20 employees who offer group health plan coverage to employees who are not eligible for Medicare but do not offer coverage to employees who are eligible for Medicare. If such an employer is not required by the applicable Medicare secondary payer rules to offer group health plan coverage to employees who are eligible for Medicare coverage, then the employer’s reimbursement of Medicare part B or D premiums may be integrated with Medicare and deemed to satisfy the annual dollar limit prohibition and the preventive services requirements if the employees who are not offered other group health plan coverage would be eligible for that group health plan but for their eligibility for Medicare. The regulations are effective on 1/19/16 and apply to group health plans and health insurance issuers beginning on the first day of the first plan year (or, in the individual market, the first day of the first policy year) beginning on or after 1/1/17.
d. Just in time for Christmas! The IRS continues to prove that the Affordable Care Act, like the jelly-of-the-month club, is, as cousin Eddie put it, “the gift that keeps on giving [guidance] the whole year.” Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). This notice, in Q&A format, provides guidance on the application of various provisions of the Affordable Care Act to employer-provided health coverage. The notice supplements the guidance in Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13) and T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The notice (1) provides guidance on the application of the Affordable Care Act’s market reforms for group health plans to various types of employer health care arrangements, including health reimbursement arrangements and group health plans under which an employer reimburses an employee for some or all of the premium expenses incurred for an individual health insurance policy; (2) clarifies certain aspects of the employer shared responsibility provisions of § 4980H; (3) clarifies certain aspects of the application to government entities of § 4980H, the information reporting provisions for applicable large employers under § 6056, and application of the rules for health savings accounts to persons eligible for benefits administered by the Department of Veterans Affairs; (4) clarifies the application of the COBRA continuation coverage rules to unused amounts in a health flexible spending arrangement carried over and available in later years, and conditions that may be put on the use of carryover amounts; and (5) addresses relief from penalties under §§ 6721 and 6722 that has been provided for employers that make a good faith effort to comply with the requirements under § 6056 to report information about offers made in calendar year 2015. The guidance provided in the notice generally applies for plan years beginning on and after 12/16/15, but taxpayers can apply the guidance provided in the notice for all prior periods.

e. Colleges and universities providing health insurance premium reductions to students who perform services might have employer payment plans that violate the Affordable Care Act’s market reforms, and may need to look at alternatives. Notice 2016-17, 2016-9 I.R.B. 358 (2/5/16). Colleges and universities often provide students, especially graduate students, with health coverage at greatly reduced or no cost as part of a package that includes tuition assistance and a stipend for living expenses. Some of these students perform services for the school (such as teaching or research), which raises the issue whether these premium reduction arrangements might be viewed as employer-sponsored group health plans that are employer payment plans that violate the market reform provisions of the Affordable Care Act. The notice concludes that whether such arrangements constitute group health plans will depend on all of the facts and circumstances, and that they might or might not be viewed as employer payment plans. To give colleges and universities time to examine this issue and adopt suitable alternatives if necessary, the notice provides that Treasury (and the Department of Labor and the Department of Health and Human Services) will not assert that a premium reduction arrangement fails to satisfy the Affordable Care Act’s market reforms if the arrangement is offered in connection with other student health coverage (either insured or self-insured) for a plan year or policy year beginning before 1/1/17. Thus, colleges and universities have relief for plan years or policy years that are roughly coterminous with academic years beginning in the summer or fall of 2016 and ending in 2017. This notice applies for plan years beginning before 1/1/17.

f. Congress provides relief from the § 4980D excise tax for small employers offering health reimbursement arrangements, imposes new reporting requirements, limits the exclusion from gross income under § 106, and coordinates HRAs with the § 36B premium tax credit. The 21st Century Cures Act (“Cures Act”), Pub. L. No. 114-255, was signed by the President on 12/13/16. Among other changes, the Cures Act made several modifications to the rules related to health reimbursement arrangements.

Health Reimbursement Arrangements Offered by Small Employers—Section 18001(a)(1) of the Cures Act amends Code § 9831 by adding subsection (d), which provides that, for purposes of title 26 (other than the Cadillac Tax of § 4980I), a “qualified small employer health reimbursement arrangement” (QSEHRA) is not treated as a group health plan. The effect of this
amendment is to allow employers to offer health reimbursement arrangements that meet the definition of a QSEHRA without becoming subject to the excise tax of § 4980D. An arrangement is a QSEHRA if it (1) is offered by an “eligible employer”; (2) subject to certain exceptions, is provided to all “eligible employees” on the same terms, (3) is funded solely by the employer and does not call for contributions through salary reduction; (4) provides for the payment or reimbursement of documented expenses for medical care (as defined in § 213(d)) incurred by the employee or the employee’s family members; and (5) the amount of payments and reimbursements for the year do not exceed $4,950 ($10,000 in the case of an arrangement that also provides for payments or reimbursements for family members of the employee). These dollar limitations will be adjusted for inflation after 2016. An “eligible employer” is an employer that is not an applicable large employer as defined in § 4980H(c)(2) and does not offer a group health plan to any of its employees. An “eligible employee” generally is any employee of the employer, but the terms of the arrangement may exclude from consideration certain employees, such as those who have not completed 90 days of service, those who have not attained age 25, and part-time or seasonal employees. This relief from the § 4980D excise tax applies for years beginning after 12/31/16, which means that employers may begin offering QSEHRAs beginning in 2017.

New Reporting Obligations—The Cures Act imposes two new reporting requirements related to health reimbursement arrangements. First, Code § 9831(d)(4), as added by § 18001(a)(1) of the Cures Act, provides that an employer funding a QSEHRA for any year must provide to each eligible employee a written notice not later than 90 days before the beginning of the year (or, if later, the date on which the employee becomes an eligible employee). The notice must include the following information: (1) a statement of the amount of the employee’s permitted benefit under the arrangement for the year; (2) statement that the employee should provide the amount of his or her permitted benefit to any health insurance exchange to which the employee applies for advance payment of the premium tax credit; and (3) a statement that, if the employee is not covered under minimum essential coverage for any month, the employee may be subject to tax under section § 5000A for that month and reimbursements under the arrangement may be includible in gross income. An employer that fails to provide the required notice is subject to a $50 penalty per employee for each incident of failure, subject to a $2,500 calendar year maximum for all failures. Second, new Code § 6501(a)(15), as added by § 18001(a)(6) of the Cures Act, requires an employer to report on Form W-2 the amount of each employee’s permitted benefit under a QSEHRA. These rules regarding reporting apply to years beginning after 12/31/16. However, the legislation provides that a person shall not be treated as failing to provide the written notice required by § 9831(d)(4) if the notice is provided not later than 90 days after the date of the enactment of the Cures Act.

Extension of Relief Provided by Notice 2015-17—Notice 2015-17, 2015-14 I.R.B. 845 (2/18/15), provided a transition rule under which the IRS would not assert the excise tax imposed by § 4980D for any failure to satisfy the market reforms by employer payment plans that pay or reimburse employees for individual health policy premiums or Medicare part B or Part D premiums: (1) for 2014 for employers that are not applicable large employers for 2014, and (2) for 1/1/15 through 6/30/15 for employers that are not applicable large employers for 2015. Section 18001(a)(7)(B) of the Cures Act provides that the relief under Notice 2015-17 shall be treated as applying to any plan year beginning on or before 12/31/16. This means that employers that are not applicable large employers will not be subject to the § 4980D excise tax as a result of offering an employer payment plan for plan years beginning on or before 12/31/16.

Limitation on the Exclusion of Code § 106—New Code § 106(g), as added by § 18001(a)(2) of the Cures Act, provides that, for purposes of Code §§ 105 and 106, payments or reimbursements to an individual for medical care from a QSEHRA shall not be treated as paid or reimbursed under employer-provided coverage for medical expenses under an accident or health plan if, for the month in which the medical care is provided, the individual does not have minimum essential coverage within the meaning of § 5000A(f). The effect of this amendment is that payments or reimbursements under a QSEHRA are included in an individual’s gross income if the individual does not have minimum essential coverage.
Coordination with the § 36B Premium Tax Credit—Code § 36B(c)(4), as added by § 18001(a)(3) of the Cures Act, makes an individual ineligible for the § 36B premium tax credit for any month if the individual is provided a QSEHRA for the month that constitutes affordable coverage. If the QSEHRA does not constitute affordable coverage, then the employee remains eligible for the premium tax credit for the month, but the amount of the credit is reduced by the 1/12 of the employee’s permitted benefit under the QSEHRA for the year. A QSEHRA constitutes affordable coverage for a month (and therefore makes an employee ineligible for the premium tax credit) if the excess of (1) the premium for the month for self-only coverage under the second lowest cost silver plan offered in the relevant individual health insurance market, over (2) 1/12 of the employee’s permitted benefit under the QSEHRA, exceeds 1/12 of 9.69 percent (for 2017) of the employee’s household income. (Note that this calculation requires using the cost of self-only coverage, even for employees with insured family members.) The statutory rules provide for adjusting the calculation in the case of employees employed for less than a full year. An employee must provide the amount of his or her permitted benefit to any health insurance exchange to which the employee applies for advance payment of the premium tax credit.

Application of the Cadillac Tax—Generally, § 4980I, which was enacted as part of the Affordable Care Act, imposes a 40 percent excise tax on the amount by which the cost of group health coverage provided by an employer (referred to as “applicable employer-sponsored coverage”) exceeds a specified dollar limit. Subsequent to the enactment of the Affordable Care Act, Congress in 2015 delayed the effective date of the Cadillac Tax to taxable years beginning after 12/31/19. Section 18001(a)(4) of the Cures Act amends Code § 4980I(d)(2)(D) to provide that a QSEHRA is considered “applicable employer-sponsored coverage” for purposes of the Cadillac Tax. Accordingly, the cost of a QSEHRA to the employer must be taken into account in determining the applicability of the Cadillac Tax.

g. Employers offering Qualified Small Employer Health Reimbursement Arrangements in 2017 need not provide the initial written notice to employees until after the IRS provides guidance. Notice 2017-20, 2017-11 I.R.B. 1010 (2/27/17). The 21st Century Cures Act, signed by the President on 12/13/16, added Code § 9831(d)(4), which requires each employer that funds a QSEHRA to provide each eligible employee a written notice with specified information not later than 90 days before the beginning of the year (or, if later, the date on which the employee becomes an eligible employee). For 2017, the legislation provides that employers will be treated as complying with this requirement if they provide the notice not later than 90 days after the date of enactment of the Cures Act. The 90th day was 3/13/17. An employer that fails to provide the required notice is subject to a $50 penalty per employee for each incident of failure, subject to a $2,500 calendar year maximum for all failures. Because employers might have difficulty complying with the notice requirement in the absence of guidance, the IRS has announced that employers funding QSEHRAs in 2017 need not provide the initial written notice until after the IRS issues such guidance.

2. Providers of minimum essential health coverage and employers subject to the Affordable Care Act’s shared responsibility payment get a break—statements required to be furnished to individuals for 2016 have a delayed due date, but the date for filing with the IRS remains unchanged. Notice 2016-70, 2016-49 I.R.B. 784 (11/18/16). Sections 6055 and 6056 were added to the Code by the Patient Protection and Affordable Care Act. Section 6055 requires annual information reporting by health insurance issuers, self-insuring employers, government agencies, and other providers of health coverage and requires the provider to furnish a related statement to each individual whose information is reported. The IRS has designated Forms 1094-B and 1095-B to meet the requirements of § 6055. Section 6056 requires annual information reporting by applicable large employers relating to the health insurance that the employer offers (or does not offer) to its full-time employees and requires the employer to furnish related statements to employees that employees may use to determine whether, for each month of the calendar year, they may claim on their individual tax returns a premium tax credit under § 36B. The IRS has designated Forms 1094-C and 1095-C to meet the requirements of § 6055. The IRS and Treasury previously issued final regulations implementing these reporting
requirements. T.D. 9660, Information Reporting of Minimum Essential Coverage, 79 F.R. 13220 (3/10/14); T.D. 9661, Information Reporting by Applicable Large Employers on Health Insurance Coverage Offered Under Employer-Sponsored Plans, 79 F.R. 13231 (3/10/14). Under the final regulations, the required statements generally must be furnished to individuals or employees for a calendar year on or before January 31 of the succeeding year, and the information returns for a calendar year generally must be filed on or before February 28 of the succeeding year (March 31 if filed electronically). The regulations generally apply for calendar years beginning after 12/31/14. This notice extends the due date for furnishing to individuals the 2016 Forms 1095-B and 1095-C to 3/2/17. Because of this extension, those furnishing Forms 1095-B and 1095-C do not have, as they normally would, the ability to request a 30-day extension. However, this notice, unlike similar relief granted in prior years, does not extend the due date for filing with the IRS Forms 1094-B, 1095-B, 1094-C, or 1095-C. The due date for filing remains 2/28/17, if not filed electronically, or 3/31/17, if filed electronically. Nevertheless, an automatic 30-day extension of the due date for filing is available by filing Form 8809 on or before the due date.

- Because the extended due dates may delay an individual’s receipt of Forms 1095-B or 1095-C, the notice provides that, for 2016, individuals do not need to wait to receive Forms 1095-B and 1095-C before filing their returns. Instead, taxpayers can rely on other information received from their employers or coverage providers about their offers of coverage for purposes of determining either eligibility for the § 36B premium tax credit or to confirm that they had minimum essential coverage. Such individuals should keep the information on which they rely with their tax records but need not send it to the IRS.

- The notice extends transition relief from penalties under §§ 6721 and 6722 for incorrect or incomplete information reported on the return or statement to reporting entities that establish they made good-faith efforts to comply with the information-reporting requirements under §§ 6055 and 6056 for 2016 (both for furnishing to individuals and for filing with the Service). However, no penalty relief is available for failing to file an information return or furnish a statement by the due dates (as extended by the notice).

B. Qualified Deferred Compensation Plans

1. IRA trustees and plan administrators can take the taxpayer’s word for it that the taxpayer is eligible for a waiver of the 60-day rollover period. Rev. Proc. 2016-47, 2016-37 I.R.B. 346 (8/24/16). This revenue procedure provides for a self-certification procedure (subject to verification on audit) that a taxpayer can use to claim eligibility for a waiver with respect to a rollover into a qualified plan or IRA. Under §§ 402(c)(3) and 408(d)(3), any amount distributed from a qualified plan or IRA is excluded from gross income if it is transferred to an eligible retirement plan no later than the 60th day following the day of receipt. A similar rule applies to § 403(a) annuity plans, § 403(b) tax sheltered annuities, and § 457 eligible governmental plans. A taxpayer who fails to meet the 60-day requirement can seek a waiver, pursuant to §§ 402(c)(3)(B) and 408(d)(3)(I), on the grounds that “failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.” Taxpayers seek a waiver by submitting a request for a private letter ruling pursuant to Rev. Proc. 2003-1 C.B. 359. This revenue procedure does not eliminate a taxpayer’s ability to seek a private letter ruling, but allows a taxpayer to make a written self-certification to a plan administrator or an IRA trustee provided that three conditions are met: (1) the IRS has not previously denied a waiver request with respect to the rollover, (2) the taxpayer failed to meet the 60-day requirement because of the taxpayer’s inability to complete a rollover due to one or more of several specified reasons, including an error by the financial institution receiving the contribution or making the distribution, the taxpayer’s misplacement and failure to cash the distribution check, severe damage to the taxpayer’s principal residence, incarceration of the taxpayer, serious illness of the taxpayer or a member of the taxpayer’s family, or the death of a member of the taxpayer’s family, and (3) the taxpayer makes the contribution to the plan or IRA as soon as practicable after the circumstance justifying the waiver no longer prevents the taxpayer from
making the contribution. (This third requirement is deemed to be satisfied if the contribution is made within 30 days after the circumstance justifying the waiver no longer prevents the taxpayer from making the contribution.) The revenue procedure provides a model letter that taxpayers can use for a self-certification. A plan administrator or IRA trustee can rely on a taxpayer’s self-certification in determining whether the taxpayer has satisfied the conditions for a waiver of the 60-day rollover requirement unless the administrator or trustee has actual knowledge to the contrary. However, IRA trustees will be required to report on Form 5498 that a contribution was accepted after the 60-day deadline. The self-certification allows a taxpayer to report a contribution as a valid rollover, but the IRS can challenge on audit the taxpayer’s eligibility for a waiver and can still seek to impose penalties such as the failure-to-pay penalty of § 6651. The revenue procedure modifies Rev. Proc. 2003-16 by providing that the IRS may grant a waiver during an examination of the taxpayer’s income tax return. The revenue procedure is effective on 8/24/16.

2. Retirement plans can make loans and hardship distributions to victims of natural disasters.

a. Relief for Louisiana flood victims. Announcement 2016-30, 2016-37 I.R.B. 355 (8/30/16). Section 401(k) plans and similar employer-sponsored retirement plans can make loans and hardship distributions to victims of flooding that began in Louisiana on August 11, 2016. Participants in § 401(k) plans, employees of public schools and tax-exempt organizations with § 403(b) tax-sheltered annuities, as well as state and local government employees with § 457(b) deferred-compensation plans, may be eligible to take advantage of these streamlined loan procedures and liberalized hardship distribution rules. IRA participants are barred from taking out loans, but may be eligible to receive distributions under liberalized procedures. Pursuant to this relief, an eligible plan will not be treated as failing to satisfy any requirement under the Code or regulations merely because the plan makes a loan, or a hardship distribution for a need arising from these Louisiana storms, to an employee, former employee, or certain family members who live or work in one of the parishes identified as part of a covered disaster area because of the Louisiana storms. To qualify for this relief, hardship withdrawals must be made by 1/17/17. To facilitate access to plan loans and distributions, the IRS will not treat a plan as failing to follow procedural requirements for plan loans or distributions imposed by the terms of the plan merely because those requirements are disregarded for any period beginning on or after 8/11/16 and continuing through 1/17/17, provided the plan administrator (or financial institution in the case of IRAs) makes a good-faith diligent effort under the circumstances to comply with those requirements. As soon as practicable, the plan administrator (or financial institution in the case of IRAs) must make a reasonable attempt to assemble any forgone documentation.

- This relief means that a retirement plan can allow a victim of the Louisiana flooding to take a hardship distribution or borrow up to the specified statutory limits from the victim’s retirement plan. It also means that a person who lives outside the disaster area can take out a retirement plan loan or hardship distribution and use it to assist a son, daughter, parent, grandparent or other dependent who lived or worked in the disaster area.
- A plan is allowed to make loans or hardship distributions before the plan is formally amended to provide for such features. Plan amendments to provide for loans or hardship distributions must be made no later than the end of the first plan year beginning after 12/31/16. In addition, the plan can ignore the reasons that normally apply to hardship distributions, thus allowing them, for example, to be used for food and shelter.
- Except to the extent the distribution consists of already-taxed amounts, a hardship distribution made pursuant to this relief will be includible in gross income and generally subject to the 10-percent additional tax of § 72(t).

b. Relief for victims of Hurricane Matthew. Announcement 2016-39, 2016-45 I.R.B. 720 (10/21/16). Similar relief allows § 401(k) plans and similar employer-sponsored retirement plans to make loans and hardship distributions to victims of Hurricane Matthew. Pursuant to this relief, an eligible plan will not be treated as failing to satisfy any requirement under the Code or regulations merely because the plan makes a loan, or a hardship
distribution for a need arising from Hurricane Matthew, to an employee, former employee, or certain family members who live or work in one of the counties identified as part of a covered disaster area because of Hurricane Matthew. To qualify for this relief, hardship withdrawals must be made by 3/15/17. To facilitate access to plan loans and distributions, the IRS will not treat a plan as failing to follow procedural requirements for plan loans or distributions imposed by the terms of the plan merely because those requirements are disregarded for any period beginning on or after 10/4/16 (10/3/16 for Florida) and continuing through 3/15/17, provided the plan administrator (or financial institution in the case of IRAs) makes a good-faith diligent effort under the circumstances to comply with those requirements. As soon as practicable, the plan administrator (or financial institution in the case of IRAs) must make a reasonable attempt to assemble any forgone documentation. A qualified employer plan that does not provide for them must be amended to provide for loans or hardship distributions no later than the end of the first plan year beginning after 12/31/16.


- Elective deferral in §§ 401(k), 403(b), and 457 plans remains unchanged at $18,000 with a catch up provision for employees aged 50 or older of $6,000.
- The limit on contributions to an IRA will be unchanged at $5,500. The AGI phase out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $62,000 to $72,000 (from $61,000-$71,000) for single filers and heads of household, increased to $99,000-$119,000 (from $98,000-$118,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to $186,000-$196,000 (from $184,000-$194,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $186,000-$196,000 (from $184,000-$194,000) for married couples filing jointly, and increased to $118,000-$133,000 (from $117,000-$132,000) for singles and heads of household.
- The annual benefit from a defined benefit plan under § 415 is increased to $215,000 (from $210,000).
- The limit for defined contribution plans is increased to $54,000 (from $53,000).
- The amount of compensation that may be taken into account for various plans is increased to $270,000 (from $265,000), and is increased to $400,000 (from $395,000) for government plans.
- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $62,000 (from $61,500) for married couples filing jointly, increased to $46,500 (from $46,125) for heads of household, and increased to $31,000 (from $30,750) for singles and married individuals filing separately.

### C. Nonqualified Deferred Compensation, Section 83, and Stock Options

### D. Individual Retirement Accounts

1. A lesson on how not to handle a deceased spouse’s IRA. Ozimkoski v. Commissioner, T.C. Memo. 2016-228 (12/19/16). The will of the taxpayer’s deceased husband appointed the taxpayer as personal representative and, with minor exceptions, left all of his property to the taxpayer. The taxpayer and her deceased husband each had a traditional IRA with Wachovia (later acquired by Wells Fargo). The deceased husband’s adult son, who was the taxpayer’s stepson, petitioned the probate court to revoke the will. In settlement of the stepson’s claims, the taxpayer and the stepson agreed that the taxpayer would transfer to the stepson a 1967 Harley Davidson motorcycle and $110,000. The agreement provided that “[a]ll payments shall be net payments free of any tax.” Because of the stepson’s claims, Wachovia froze the deceased husband’s IRA. In 2008, following the settlement, Wachovia transferred approximately $235,000 from the deceased husband’s IRA to the taxpayer’s IRA. The taxpayer, who was age 53, then withdrew a total of approximately $175,000 from her IRA during 2008, $110,000 of which she paid to the stepson. Wachovia issued a Form 1099-R reporting the distributions as early distributions. The taxpayer filed her 2008 income tax return twenty-four days late and did
not include the IRA distributions in her gross income. The IRS issued a notice of deficiency asserting an income tax deficiency of $62,185, a § 72(t) penalty tax for early withdrawal by a taxpayer not yet age 59-1/2 of $17,460, a late-filing penalty of $3,100, and an accuracy-related penalty of $12,437 for substantial understatement of income tax. The taxpayer, who appeared pro se, argued that $110,000 of the distributions should not be included in her gross income because the stepson was entitled to that amount through the probate litigation and resulting settlement. The Tax Court (Judge Paris) first concluded that Wachovia had incorrectly rolled the deceased husband’s IRA into the taxpayer’s IRA because she was not a named beneficiary of the deceased husband’s IRA. In the court’s view, Wachovia should have distributed the assets of the deceased husband’s IRA to his estate. Nevertheless, the court reasoned that it could not unwind that transaction and had to decide the issues based on the transfers that had actually occurred. The court held that the taxpayer had to include in her gross income all of the 2008 distributions from her IRA, including the $110,000 that she paid to her stepson. The court also upheld the imposition of the § 72(t) penalty tax. Although an exception § 72(t)(2)(A)(ii) provides that the penalty tax does not apply to distributions “made to a beneficiary (or to the estate of the employee) on or after the death of the employee,” the court relied on prior decisions, including Gee v. Commissioner, 127 T.C. 1 (2006), to conclude that the exception does not apply where, as here, a beneficiary rolls over the funds from a deceased spouse’s IRA into his or her IRA and then withdraws funds from his or her IRA. The court also upheld the late-filing penalty because the taxpayer had failed to establish that the late filing was due to reasonable cause and not due to willful neglect. However, the court held that, taking into account all the circumstances, including the taxpayer’s experience, knowledge, and education, the taxpayer had established a reasonable cause, good faith defense to the accuracy-related penalty with respect to the portion of the understatement attributable to the $110,000 the taxpayer paid to her stepson (but not with respect to the portion attributable to the remaining $65,000 in distributions).

• It appears to us that, with proper advice and planning, the taxpayer could have avoided both the 10 percent penalty of § 72(t) and the inclusion in her gross income of the $110,000 she paid to her stepson. Rather than transfer the $235,000 balance of her deceased husband’s IRA into her own IRA, the taxpayer could have left the funds in her deceased husband’s IRA. This should have permitted a direct payment of $110,000 from her deceased husband’s IRA to the stepson without inclusion of those funds in her gross income. It also should have permitted her to avoid the 10 percent penalty by taking advantage of the exception in § 72(t)(2)(A)(ii).

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. The Treasury Department and the IRS are trying to get everyone to sing Kumbaya. T.D. 9785. Definition of Terms Relating to Marital Status, 81 F.R. 60609 (9/2/16). The Treasury Department and the IRS have finalized, with some changes, proposed regulations that reflect the holdings of Obergefell v. Hodges, 576 U.S. ___, 135 S. Ct. 2584 (2015), Windsor v. United States, 570 U.S. ___, 133 S. Ct. 2675 (2013), and Rev. Rul. 2013-17, 2013-38 I.R.B. 201, defining and describing the marital status of taxpayers (REG-148998-13, Definition of Terms Relating to Marital Status, 80 F.R. 64378 (10/23/15)). Reg. § 301.7701-18 amends the current regulations under § 7701 to provide that for federal tax purposes the terms “spouse,” “husband,” and “wife” mean an individual lawfully married to another individual, and the term “husband and wife” means two individuals lawfully married to each other. These definitions apply regardless of sex. However, the terms “spouse,” “husband,” and “wife” do not include individuals who have entered into a registered domestic partnership, civil union, or other similar relationship not denominated as a marriage under the law of a state, possession, or territory of the United States; the term “husband and wife” does not include couples who have entered into such a relationship, and the term “marriage” does not include such relationships.

• Effective date. The regulations apply to taxable years ending on or after 9/2/16. In reality, however, as a result of the holdings in Obergefell, Windsor, and Rev. Rul. 2013-17, these rules are already in effect.
B. Miscellaneous Income

1. An exclusion from gross income for wrongfully incarcerated individuals. The 2015 PATH Act, § 304, adds to the Code § 139F, which excludes from the gross income of an individual who is convicted of a criminal offense under federal or state law and wrongfully incarcerated any civil damages, restitution, or other monetary award relating to the individual’s incarceration. An individual was wrongfully incarcerated if the individual is pardoned, granted clemency, or granted amnesty for the offense because the individual was innocent, or if the conviction is reversed or vacated and the charging instrument is then dismissed or the individual is found not guilty at a new trial. The new provision applies to taxable years beginning before, on, or after 12/18/15, the date of enactment. A special rule allows individuals to make a claim for credit or refund of any overpayment of tax resulting from the exclusion, even if the claim would normally be barred by operation of any law or rule of law (including res judicata), if the claim for credit or refund is filed before the close of the one-year period beginning on 12/18/15.

   a. Amounts received by a person other than the wrongfully incarcerated individual are not eligible for the § 139F exclusion. In re Elkins, 117 A.F.T.R.2d 2016-2124 (Bankr. N.D. Ohio 6/14/16). Clarence Elkins was convicted of rape and murder and was incarcerated for seven years. He was exonerated and filed a lawsuit based on his wrongful conviction and incarceration in which he asserted claims for loss of consortium on behalf of his wife and son, who were debtors in a Chapter 7 bankruptcy proceeding. Mr. Elkins and his family received a settlement of $5.25 million, of which his wife and son had shares of $611,000 and $627,000 respectively. The bankruptcy trustee filed tax returns for the bankruptcy estates including part of their shares of the settlement in gross income. The bankruptcy proceeding was closed in 2014. Following Congress’s enactment of § 139F in 2015, the wife and son sought to reopen their bankruptcy cases to file amended bankruptcy estate tax returns to exclude the settlement proceeds previously included in gross income. The Bankruptcy Court (Judge Kendig) denied their motions to reopen because doing so would be futile. The court reasoned that the exclusion of § 139F is available only to the wrongfully incarcerated individual, not to other persons, such as Mr. Elkins’ wife and son. The court supported its conclusion by reference to the language of § 139F, which provides in subsection (a):

   In the case of any wrongfully incarcerated individual, gross income shall not include any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the covered offense for which such individual was convicted.

2. Hallelujah! The government finally recognizes that nonpayment of a debt still owed is not necessarily COD income. T.D. 9793, 81 F.R. 78908 (11/10/16). The IRS and Treasury have finalized proposed amendments (REG-136676-13, Removal of the 36-Month Non-Payment Testing Period Rule, 79 F.R. 61791 (10/15/14)) to Reg. § 1.6050P-1 that eliminate the rule that a deemed discharge of indebtedness for which a Form 1099-C, “Cancellation of Debt,” must be filed occurs at the expiration of a 36-month non-payment testing period. The Preamble explains the change as follows:

   Because reporting under the 36-month rule may not reflect a discharge of indebtedness, a debtor may conclude that the debtor has taxable income even though the creditor has not discharged the debt and continues to pursue collection. Issuing a Form 1099-C before a debt has been discharged may also cause the IRS to initiate compliance actions even though a discharge has not occurred. Additionally, § 1.6050P–1(e)(9) provides that no additional reporting is required if a subsequent identifiable event occurs. Therefore, in cases in which the Form 1099–C is issued because of the 36-month rule but before the debt is discharged, the IRS does not subsequently receive third-party reporting when the debt is discharged. The IRS’s ability to enforce collection of tax for discharge of indebtedness income may, thus, be diminished when the information reporting does not reflect an actual cancellation of indebtedness.
The final regulations are applicable to information returns required to be filed, and payee statements required to be furnished, after 12/31/16. The deadline for filing information returns and furnishing payee statements for calendar year 2016 is after 12/31/16. Accordingly, the expiration of a 36-month testing period during 2016 does not trigger a requirement to file information returns and furnish payee statements. (This effective date is a change from the proposed regulations, which were proposed to be effective and applicable as of the date of publication of final regulations in the Federal Register.)

C. Hobby Losses and § 280A Home Office and Vacation Homes

D. Deductions and Credits for Personal Expenses

1. Proposed and temporary regulations on deducting casualty losses in the preceding tax year. T.D. 9789, Election to Take Disaster Loss Deduction for Preceding Year, 81 F.R. 70938 (10/14/16). The Treasury Department and the IRS have issued proposed and temporary regulations under § 165(i), which allows a taxpayer to elect to treat an allowable loss occurring in a disaster area and attributable to a federally declared disaster as a casualty loss sustained in the tax year immediately prior to the tax year in which the disaster occurred (preceding year). The temporary regulations generally provide that the due date for making the § 165(i) election is six months after the due date for filing the taxpayer’s federal income tax return for the disaster year (determined without regard to any extension of time to file). The temporary regulations also extend the period of time for revoking a § 165(i) election to ninety days after the due date for making the election. The temporary regulations are effective immediately.

a. Guidance on the manner of making the § 165(i) election. Rev. Proc. 2016-53, 2016-44 I.R.B. 530 (10/13/16). This revenue procedure sets forth the rules and procedures regarding the election under § 165(i) (and the revocation of a § 165(i) election) to deduct a disaster loss for the tax year immediately preceding the tax year in which the disaster occurred. Generally, a taxpayer makes the election by deducting the disaster loss on either an original federal tax return or an amended federal tax return for the preceding year. A taxpayer must include with the original or amended return an election statement indicating the taxpayer is making a § 165(i) election. For an election made on an original return, a taxpayer must provide the information required by section 3.02 of the revenue procedure on Lines 1 or 19 (as applicable) of Form 4684 (Casualties and Thefts). (A taxpayer filing an original federal tax return electronically may attach a statement as a PDF document if there is insufficient space on Form 4684 to provide the required information.) For an election made on an amended return, a taxpayer may provide the required information by any reasonable means.

2. Proposed regulations address reporting requirements and related issues for education tax credits allowed by § 25A. REG-131418-14, Reporting for Qualified Tuition and Related Expenses; Education Tax Credits, 81 F.R. 50657 (8/2/16). The Treasury Department and the IRS have issued proposed amendments to (1) the regulations under § 25A and § 6050S to reflect amendments to §§ 25A and 6724 under the Trade Preferences Extension Act of 2015, Pub. L. No. 114-27 (TEA) and amendments to §§ 25A and 6050S under the 2015 PATH Act, and (2) the regulations under § 25A to update the definition of qualified tuition and related expenses to reflect changes made by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (ARRA), to clarify the prepayment rule in Reg. § 1.25A-5(e), and to clarify the rule for refunds in Reg. § 1.25A-5(f). Among other requirements, the proposed regulations implement the TPEA’s requirement for qualified tuition and related expenses paid in tax years beginning after 6/29/15 that taxpayers must receive a Form 1098-T to claim an education credit (the American Opportunity Tax Credit or Lifetime Learning Credit) under § 25A or the deduction under § 222; the 2015 PATH Act’s requirement that the American Opportunity Tax Credit is not allowed if the TIN of the student or the taxpayer claiming the deduction is issued after the due date for filing the return or if the return does not include the EIN of the educational institution to which tuition was paid; and the 2015 PATH Act’s requirement that educational institutions must report on Form 1098-T amounts paid, rather than amounts billed, effective for amounts paid after 12/31/15 for education furnished in academic periods beginning after that
The proposed regulations will be effective upon publication in the Federal Register as final regulations.

- The IRS previously issued Announcement 2016-17, 2016-20 I.R.B. 853 (4/27/16), which states that the IRS will not impose penalties under section §§ 6721 or 6722 for failure to file or furnish correct or timely information returns solely because an eligible educational institution reports the aggregate amount billed for qualified tuition and related expenses for the 2016 calendar year.

3. Standard deduction for 2017. Rev. Proc. 2016-55, 2016-45 I.R.B. 707 (10/25/16). The standard deduction for 2017 will be $12,700 for joint returns and surviving spouses (increased from $12,600), $6,350 for unmarried individuals and married individuals filing separately (increased from $6,300), and $9,350 for heads of households (increased from $9,300).

4. A dependency exemption, but not the child tax credit, is available for a permanently and totally disabled child who has attained age seventeen. Polsky v. United States, 844 F.3d 170 (3d Cir. 12/15/16). The taxpayers, a married couple appearing pro se, had a daughter who was permanently disabled and who was over age seventeen. For the years 2010 and 2011, the taxpayers claimed a child tax credit with respect to their daughter under § 24. The IRS disallowed the credit on the ground that their daughter had attained age seventeen. Section 24(c)(1) allows the credit only for a “qualifying child,” defined in § 24(c)(1) as “a qualifying child of the taxpayer (as defined in section 152(c)) who has not attained age 17.” The taxpayers argued that the credit nevertheless was available because the cross-reference in § 24(c)(1) to § 152(c) incorporates § 152(c)(3)(B), which states that a child is a qualifying child without regard to the child’s age if the child is permanently and totally disabled. In a per curiam opinion, the U.S. Court of Appeals for the Third Circuit affirmed the District Court and held that the child tax credit is available only when the qualifying child both “meets the non-age-related requirements of § 152(c) and ‘has not attained age 17.’” Accordingly, the taxpayers were not entitled to the credit. The court quoted from the District Court’s opinion:

Section 24 imports the basic qualifications from § 152(c), and adds an age limitation of seventeen years. ... The age restriction in § 24(c)(1) is intended to end the tax credit when the child reaches seventeen years of age. In contrast, the special rule applicable to permanently and totally disabled dependents in § 152(c)(3)(B) is calculated to extend the tax deduction as long as the child is disabled. Therefore, the taxpayer can take a dependent deduction regardless of the child’s age as long as the child is permanently and totally disabled, but cannot receive a tax credit for a disabled child who, by the close of the taxable year, was seventeen years of age.

5. Proposed regulations address several issues related to the definition of a dependent. REG-137604-07, Definition of Dependent, 82 F.R. 6370 (1/19/17). The Treasury Department and the IRS have issued proposed regulations that address several issues related to the definition of a dependent. Section 151 authorizes the deduction of an exemption amount for each dependent as defined in § 152. The term “dependent” also is relevant for purposes of other Code provisions. Generally, the term “dependent” is defined in § 152(a) as a qualifying child or a qualifying relative. The following summary discusses some of the highlights of the proposed regulations.

Relationship Test (Qualifying Child and Qualifying Relative)—Under § 152(d)(1), an individual can be a qualifying relative of a taxpayer only if, among other requirements, the individual is not a qualifying child of the taxpayer or any other taxpayer. This rule could prevent a taxpayer from claiming a dependency exemption deduction for an unrelated child that the taxpayer supports, e.g., if the unrelated child and the child’s parent both live with the taxpayer. The proposed regulations adopt the rule in Notice 2008-5, 2008-2 I.R.B. 256 (12/18/2007), and provide that an individual is not a qualifying child of a person if that person (1) is not required to file an income tax return under § 6012, and (2) either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes.
Residency Test (Principal Place of Abode)—For a person to be a qualifying child of a taxpayer under § 152(c)(1), the person must, among other requirements, have the same principal place of abode as the taxpayer for more than one-half of the taxable year. Similarly, under § 152(d), a person other than the taxpayer’s spouse can be a qualifying relative of the taxpayer if, among other requirements, the person has the same principal place of abode as the taxpayer and is a member of the taxpayer’s household. In Prop. Reg. § 1.152-4(c), “principal place of abode” is defined as “the primary or main home or dwelling where the taxpayer resides.” The proposed regulations provide that (1) temporary lodging such as a homeless shelter or relief housing resulting from displacement by a natural disaster may qualify as a person’s principal place of abode; (2) a person has the same principal place of abode as the taxpayer despite a temporary absence, defined as occurring “if the taxpayer would have resided at the abode but for the absence and, under the facts and circumstances, it is reasonable to assume that the person will return to reside at the place of abode;” and (3) a person is treated as having the same principal place of abode as the taxpayer for more than one-half of the taxable year if the individual resides with the taxpayer for at least 183 nights during the taxable year (or at least 184 nights during leap years). The proposed regulations provide rules for determining nights of residence.

Age Test—For a person to be a qualifying child of a taxpayer under § 152(c)(1), the person must, among other requirements, be younger than the taxpayer and, as of the close of the calendar year, not have attained the age of 19 or be a student who has not attained the age of 24. In Prop. Reg. § 1.152-1(b)(2), the term “student” is defined as an individual who, during some part of each of five calendar months during the calendar year is a full-time student at an educational organization described in § 170(b)(1)(A)(ii)—generally a school that normally maintains a regular faculty and curriculum and has a regular body of students in attendance—or is pursing a full-time course of institutional on-farm training under the supervision of specified authorities.

Support Test—For a person to be a qualifying child of a taxpayer under § 152(c)(1), the person must, among other requirements, not provide more than one-half of the person’s own support. Similarly, under § 152(d), a person can be a qualifying relative of the taxpayer if, among other requirements, the taxpayer provides more than one-half of the person’s support. According to Prop. Reg. § 1.152-4(a), “the amount of support provided by the individual, or the taxpayer, is compared to the total amount of the individual’s support from all sources.” The amount of an individual’s support from all sources generally includes support the individual provides and income that is excludable from gross income. The term “support” includes food, shelter, clothing, medical and dental care, education, and similar items for the benefit of the supported individual. Generally, governmental payments and subsidies are treated as support provided by a third party. These include Temporary Assistance for Needy Families (TANF), low-income housing assistance, benefits under the Supplemental Nutrition Assistance Program, Supplemental Security Income payments, foster care maintenance payments, and adoption assistance payments. In contrast, old age benefits under the Social Security Act, which are based on earnings, are treated as support provided by the recipient to the extent the recipient uses the benefits for support. Similarly, SSDI payments to the child of a deceased or disabled parent are treated as support provided by the child to the extent those payments are used for the child’s support. The proposed regulations provide that governmental payments used by the intended beneficiary or recipient to support another individual constitute support provided by the intended beneficiary or recipient of the payments. For example, a mother who uses TANF payments to support her children is treated as providing that support. The preamble to the proposed regulations states that the IRS will no longer assert the position it took in Lutter v. Commissioner, 61 T.C. 685 (1974), aff’d per curiam, 514 F.2d 1095 (7th Cir. 1975), in which the government successfully argued that governmental payments received by a parent and used for the support of children constituted support provided by the government.

Tiebreaker Rules and Determination of AGI of Joint Filers—Under the tiebreaker rules of § 152(c)(4), if a person meets the definition of a qualifying child for two or more taxpayers, the taxpayer who is a parent of the person may claim the person as a qualifying child. If more than one parent claims the person as a qualifying child, and if the parents do not file a joint return
with each other, then the person is treated as the qualifying child of the parent with whom the person resides for the longest period during the year. If the person resides an equal amount of time with each parent, then the person is treated as the qualifying child of the parent with the highest adjusted gross income. If no eligible parent claims the person as a qualifying child, then the person may be claimed as a qualifying child by another taxpayer only if the taxpayer’s adjusted gross income exceeds the adjusted gross income of each eligible parent and (under Prop. Reg. § 1.152-2(g)(1)(ii)) of any other taxpayer who is eligible to claim the person as a qualifying child. For purposes of these rules, Prop. Reg. § 1.152-2(g)(2) provides that the adjusted gross income of each person who files a joint return is the total adjusted gross income shown on the joint return. For example, if daughter, daughter’s husband and their three-year-old child live with daughter’s mother (grandmother), and if daughter and husband file a joint return showing total adjusted gross income of $45,000, grandmother can claim the child as a qualifying child only if daughter and husband do not do so and grandmother’s adjusted gross income exceeds $45,000. This is a change from Publication 501, Exemptions, Standard Deduction, and Filing Information, and will be reflected in revisions to Publication 501. Since 2009, Publication 501 has stated that, if a child’s parents file a joint return with each other, then the adjusted gross income of each parent is determined by dividing the parents’ combined adjusted gross income equally between them.

Noncustodial Spouse Claiming Dependency Exemption—Section 152(e)(2)(A) provides that a noncustodial parent can claim the dependency exemption only if “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.” The IRS generally requires the custodial spouse’s written declaration to be on Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents. Under Prop. Reg. § 1.152-5(e)(2)(i), the noncustodial spouse can submit the written declaration with an original return, an amended return, or during an examination of a return. However, a written declaration submitted with an amended return or during an examination will not satisfy the requirement of § 152(e) if (1) the custodial parent signed the written declaration after the custodial parent filed a return claiming a dependency exemption for the child for the year at issue, and (2) the custodial parent has not filed an amended return to remove the custodial parent’s claim of a dependency exemption.

Childless Earned Income Credit—The IRS’s position since 1995, reflected in Publication 596, Earned Income Credit, has been that, if a person meets the definition of a qualifying child for more than one taxpayer but is not treated as the qualifying child of a taxpayer under the tiebreaker rules, then the taxpayer for whom the person is not a qualifying child is precluded from claiming the childless earned income credit (the earned income credit that is available to taxpayers without a qualifying child). The proposed regulations reflect a change in the IRS’s position. According to Prop. Reg. § 1.32-2(c)(3)(ii), if a person is not a qualifying child of a taxpayer under the tiebreaker rules, then the person also is not treated as a qualifying child of the taxpayer for purposes of § 32(c)(1)(A), and therefore the taxpayer may claim the earned income credit for a taxpayer without a qualifying child if all other requirements for the earned income credit are satisfied.

Effective Date—The regulations are proposed to apply to taxable years beginning after the date final regulations are published in the Federal Register. Pending the issuance of final regulations, taxpayers can choose to apply the proposed regulations in any open tax years.

E. Divorce Tax Issues

1. The taxpayer and his former spouse might have been overly optimistic that they could continue to operate jointly owned businesses following their divorce. When things did not work out, § 1041 prevented the taxpayer from recognizing gain on the sale of his interest. Belot v. Commissioner, T.C. Memo. 2016-113 (6/13/16). During their marriage, the taxpayer and his former spouse operated three businesses: a dance school organized as a C corporation, a business engaged in the retail sale of dancewear and accessories organized as an LLC, and a real estate business organized as an LLC taxed as a partnership. During their divorce
proceeding, the taxpayer and his spouse equalized their ownership interests in the businesses and planned to continue operating them together following the divorce. A judgment of divorce was entered in January 2007. In September 2007, the taxpayer’s former spouse brought an action in which she alleged that he had mismanaged the dance school, sought to remove him as a director and employee, and asked the court to compel him to sell his shares to the corporation or to her. To resolve this litigation, the parties entered into a settlement agreement in April 2008, pursuant to which the taxpayer sold his interests in all of the businesses to his former spouse for $1.5 million, payable over a ten-year period. The IRS asserted that the taxpayer’s transfer of his interests did not qualify for nonrecognition under § 1041(a), which provides that no gain or loss is recognized on the transfer of property to a spouse or to a former spouse incident to divorce. Under § 1041(c), a transfer is incident to divorce if it occurs within one year after the date on which the marriage ceases or is related to the cessation of the marriage. The relevant regulation, Reg. § 1.1041-1T(b), Q&A-7, provides:

A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument … and the transfer occurs not more than 6 years after the date on which the marriage ceases. … Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

The Tax Court (Judge Colvin) held that the taxpayer’s transfer of his ownership interests was “incident to divorce” within the meaning of § 1041(c). In reaching this conclusion, the court rejected the government’s argument that the taxpayer’s transfer, which occurred more than one year after the date on which the marriage ceased, was not related to the cessation of the marriage because it was not made pursuant to a divorce or separation instrument. The relevant regulation, the court reasoned, contemplates that a transfer not pursuant to a divorce or separation instrument can be related to the cessation of the marriage if it is “made to effect the division of property owned by the former spouses at the time of the cessation of the marriage.” The court also rejected the government’s arguments that the transfer was not related to the cessation of the marriage because (1) it took the form of a sale, and (2) the litigation that resulted in the sale concerned a business dispute, as evidenced by the fact that the litigation was brought in the superior court civil part rather than the family court, which had jurisdiction over the taxpayer’s divorce.

2. A blue moon arrives in the Tax Court—a taxpayer successfully establishes through credible testimony that he was entitled to the dependency exemption, earned income tax credit, and child tax credit. Tsehay v. Commissioner, T.C. Memo. 2016-200 (11/3/16). The taxpayer, whose first language was not English and who worked as a custodian at a community college, filed a return on Form 1040A for 2013 through a paid preparer. On the return, the taxpayer claimed head of household filing status, a dependency exemption and the child tax credit for four children, and an earned income tax credit for three children. (It was unclear from the record why the paid preparer had listed different numbers of children for the exemptions and credits.) The IRS issued a notice of deficiency disallowing all of the claimed exemptions and credits. The notice also changed the taxpayer’s filing status to single and imposed an accuracy-related penalty under § 6662(a). The IRS took the position that the taxpayer, who had previously been separated from his wife and ordered to pay child support, was a noncustodial parent and therefore subject to § 152(e)(2), which provides that a noncustodial
The parent can claim the dependency exemption for a child only if the custodial parent signs a written declaration that the custodial parent will not claim the child as a dependent and the noncustodial parent attaches the written declaration to his or her tax return. The taxpayer had failed to submit Form 8332, the form designated for such written declarations, with his income tax return. The Tax Court (Judge Kerrigan) found credible the taxpayer’s testimony at trial. The taxpayer testified that, during 2013, he and his wife were married and lived together with their five children in a public housing apartment. Based on this testimony, the court held that the taxpayer was entitled to the dependency exemptions, the child tax credit, and the earned income tax credit. The court rejected the IRS’s reliance on a child support order to establish that the taxpayer was a noncustodial parent because the order was entered in August 2015, after the tax year in issue. Regarding his filing status, the taxpayer testified that he and his wife had separated by the time he filed his 2013 return and that he had asked the preparer to list his filing status as married filing separately. The preparer erroneously listed his filing status as head of household. The court held that his filing status could not be changed to single, as the IRS contended, but instead should be married filing separately. Although the erroneous filing status might have supported the accuracy-related penalty, the court held that the taxpayer—who had a language barrier, sought and relied on professional advice, and was separated from his wife when he filed his return—had established a reasonable cause, good faith defense.

- There appears to be some inconsistency in the court's conclusions. A taxpayer whose filing status is married filing separately cannot claim the earned income tax credit.

F. Education
G. Alternative Minimum Tax

VI. CORPORATIONS

VII. PARTNERSHIPS

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING
   A. Exempt Organizations
   B. Charitable Giving

1. If you are donating a used motor vehicle, boat, or airplane, you better not neglect to obtain and attach to your return Form 1098-C, says the Tax Court. Izen v. Commissioner, 148 T.C. No. 5 (3/1/17). On 4/14/16, during a pending Tax Court proceeding, the taxpayer filed an amended federal income tax return for 2010 and claimed a charitable contribution deduction of $338,080 for his donation of a 50 percent interest in a 1969 model Hawker-Siddley DH125-400A private jet to the Houston Aeronautical Heritage Society (Society), an organization exempt from tax under § 501(c)(3), which operates a museum at the William P. Hobby Airport. The taxpayer included with his amended return: (1) an acknowledgment letter dated 12/30/10 and signed by the president of the Society; (2) a Form 8283, Noncash Charitable Contributions, dated 4/13/16 and executed by the managing director of the Society; (3) a copy of an “Aircraft Donation Agreement” allegedly executed on 12/31/10 by the president of the Society (but not by the taxpayer); and (4) an appraisal dated 4/7/11, stating that the fair market value of the taxpayer’s 50 percent interest in the aircraft, as of 12/30/10, was $338,080. The IRS moved for summary judgment and asserted that the taxpayer was not entitled to the charitable contribution deduction because he had failed to satisfy the substantiation requirements of § 170(f)(12), which applies to contributions of used motor vehicles, boats, and airplanes. Section 170(f)(8) requires a contemporaneous written acknowledgement from the donee organization as a condition for deducting charitable contributions of $250 or more, but § 170(f)(12) imposes more stringent substantiation requirements. Section 170(f)(12) requires a more detailed contemporaneous written acknowledgment and, unlike § 170(f)(8), requires the taxpayer to include the acknowledgment with the return that includes the deduction. The statute directs the donee organization to provide
to the government the information contained in the acknowledgment, and the IRS has designated for this purpose Form 1098-C, **Contributions of Motor Vehicles, Boats, and Airplanes**, a copy of which is to be provided to the donor. The taxpayer did not submit Form 1098-C with his amended return. The Tax Court (Judge Lauber) concluded that the documentation the taxpayer did submit with his amended return did not comply with the requirements of § 170(f)(12). Accordingly, the court disallowed the taxpayer’s deduction.

**X. TAX PROCEDURE**

A. Interest, Penalties, and Prosecutions

1. **More taxpayer (or nontaxpayer?) choice of forum.** Norman v. United States, 126 Fed. Cl. 277 (4/11/16). The Court of Federal Claims (Judge Merow) held that the court has jurisdiction to hear suits seeking a refund of FBAR penalties imposed under the Bank Secrecy Act. The court concluded that the scope of its subject matter jurisdiction under the Tucker Act, 28 U.S.C. § 1491(a)(1), extends to suits seeking the recovery of a penalty such as the one in this case. The court rejected the government’s argument that exclusive jurisdiction over cases involving penalties is vested in the United States District Courts by 28 U.S.C. § 1355, which provides that “[t]he district courts shall have original jurisdiction, exclusive of the courts of the States, of any action or proceeding for the recovery or enforcement of any fine, penalty, or forfeiture … incurred under any Act of Congress.” Nevertheless, the court “acknowledge[d] … that substantial ground for difference of opinion on this controlling question of law exists, so that an interlocutory appeal … may materially advance the ultimate termination of the litigation.”

2. **If an NOL falls in the forest and no one is around to hear it, does it reduce interest on a deficiency?** Interest accrues on a deficiency without reduction for a subsequent year’s NOL carried back to the deficiency year until the NOL comes into existence. United States v. Beane, 841 F.3d 1273 (11th Cir. 11/23/16). The taxpayer in this case owed interest on a deficiency in 1998 taxes, payment of which was due on 4/15/99. The taxpayer had a net operating loss in 2000 which was carried back to 1998. Among other issues, the question was whether interest on the 1998 deficiency should be calculated by using (1) the amount of the deficiency in 1998 taxes from 4/15/99 through 4/15/01, when the 2000 net operating loss became effective, or (2) the amount of the deficiency ultimately calculated by the Tax Court, which reflected a reduction by the 2000 net operating loss carryback starting as of 4/15/99? Stated differently, the issue was whether, for purposes of the interest calculation, the net operating loss carryback was effective as of 4/15/99 or 4/15/01? In an opinion by Judge Hull, the Eleventh Circuit held that the net operating loss carryback was not effective until it came into existence in 2001. In reaching this conclusion, the court relied on Manning v. Seeley Tube & Box Co. of N.J., 338 U.S. 561 (1950) as well as § 6601(d)(1), which provides:

> If the amount of any tax imposed by subtitle A is reduced by reason of a carryback of a net operating loss or net capital loss, such reduction in tax shall not affect the computation of interest under this section for the period ending with the filing date for the taxable year in which the net operating loss or net capital loss arises.

Accordingly, interest on the 1998 deficiency was calculated for the period prior to 4/15/01 without reduction to reflect the 2000 net operating loss carryback.

3. **A majority of the Tax Court refuses to call a procedural foot-fault on the IRS, but not all the judges see it that way.** Graev v. Commissioner, 147 T.C. No. 16 (11/30/16). The taxpayers had claimed a charitable contribution deduction for the donation of a facade conservation easement that ultimately was disallowed by the Tax Court (140 T.C. 377 (2013)). The IRS examining agent determined that the taxpayers were liable for the § 6662(h) 40 percent gross valuation misstatement penalty, and he prepared a penalty approval form for which he obtained written approval from his immediate supervisor. On that form only the § 6662(h) 40 percent penalty was asserted. The agent prepared a notice of deficiency that included the 40 percent penalty. However, before the notice of deficiency was issued, a Chief Counsel attorney reviewed a draft and, through a memorandum approved by his supervisor, the attorney advised that an alternative § 6662(a) 20 percent accuracy-related penalty should be
added to the notice. The notice of deficiency was revised to include the 20 percent §6662(a) accuracy-related penalty, the calculation of which in the notice of deficiency yielded a zero 20 percent penalty to avoid stacking with the 40 percent penalty. The notice of deficiency was issued as revised, but the revised notice with the alternative 20 percent penalty was not reviewed or approved by the examining agent’s supervisor. After the IRS conceded that the 40 percent gross valuation misstatement penalty did not apply, it asserted the alternative 20 percent accuracy-related penalty as a non-zero amount, since the stacking issue no longer existed. The taxpayers argued that, because the notice of deficiency showed a zero amount for the §6662(a) 20 percent penalty, the IRS failed to comply with the requirements of §6751(a), which requires that a computation of the penalty be included in the notice of deficiency, and §6751(b), which requires that the “initial determination of ... [the] assessment” of the penalty be “personally approved (in writing) by the immediate supervisor ... or such higher level official as the Secretary may designate,” and that these failures barred assessment of the 20 percent penalty. In a reviewed opinion by Judge Thornton, the Tax Court (9-3-5) held that: (1) the notice of deficiency complied with the requirements of §6751(a); (2) because the penalty had not yet been assessed, the taxpayers’ argument that the IRS failed to comply with §6751(b)(1) was premature; and (3) the 20 percent accuracy-related penalty for a substantial understatement applied. With respect to the first holding, regarding compliance with §6751(a), the court reasoned as follows:

The notice of deficiency clearly informed petitioners of the determination of the 20% penalty (as an alternative) and clearly set out the computation (albeit reduced to zero, as it had to be then, to account for the greater 40% penalty). The notice of deficiency thus complied with section 6751(a).

Moreover, even if petitioners were correct that the IRS failed to include a computation of a penalty as required by section 6751(a), such a failure would not invalidate a notice of deficiency. In similar contexts this Court has held that procedural errors or omissions are not a basis to invalidate an administrative act or proceeding unless there was prejudice to the complaining party.

With respect to the third holding regarding application of the 20 percent accuracy-related penalty, the court rejected the taxpayers’ defenses and concluded that: (1) the taxpayers had not established that they had reasonable cause for claiming the charitable contribution deductions and acted in good faith; (2) “the authorities that support [the taxpayers’] deductions for the cash and conservation easement contributions are not substantial when weighed against the contrary authorities;” and (3) the taxpayers had no reasonable basis for their return position and had not adequately disclosed on their return the relevant facts concerning their deductions because they had not disclosed a side letter from the National Architectural Trust (NAT) (the easement holder) obligating the NAT to refund the taxpayers’ cash contribution and work to remove the easement if the IRS disallowed entirely their charitable contribution deductions for the easement.

- A concurring opinion by Judge Nega (with whom Judges Goeke and Pugh joined) would have reached the same result as the majority on the ground that the taxpayers were not prejudiced, and would have left “to another case the more detailed statutory analysis performed by both the majority and the dissent.”
- A dissent by Judge Gustafson (joined by Judges Colvin, Vasquez, Morrison and Buch) would not have sustained the penalty on the ground that the IRS failed to comply with §6751(b)(1) because “the responsible revenue agent included a 20% accuracy-related penalty on the notice of deficiency without first obtaining the ‘approv[al] (in writing)’ of his ‘immediate supervisor’.”

**a. But the Second Circuit serves the Tax Court some Chai.** Chai v. Commissioner, 851 F.3d 190 (2d Cir. 3/20/17), aff’g in part, vacat’g in part, and rev’g in part T.C. Memo. 2015-42 (3/11/15). The taxpayer in this case received in 2003 a $2 million payment for serving as an accommodation party in connection with tax shelters. The taxpayer did not report the payment as income and took the position that the $2 million was a nontaxable return of capital. The IRS issued a notice of deficiency for 2003 increasing the taxpayer’s income by the
$2 million payment and asserting both a deficiency in self-employment tax and a 20 percent accuracy-related penalty. (The notice of deficiency did not assert a deficiency in income tax because the taxpayer had offsetting losses from a partnership subject to the TEFRA audit rules. Those losses ultimately were disallowed at the partnership level and the IRS amended its answer in this Tax Court proceeding to assert a deficiency in income tax. This sequence of events led to several interesting procedural issues with respect to the deficiency in income tax.) In his post-trial briefing in the Tax Court, the taxpayer raised for the first time the same argument regarding the penalty as the taxpayer had raised in Graev v. Commissioner, 147 T.C. No. 16 (11/30/16), i.e., that the IRS was barred from assessing the 20 percent accuracy-related penalty because it had failed to comply with the requirement of § 6751(b) that the “initial determination of ... [the] assessment” of the penalty must be “personally approved (in writing) by the immediate supervisor ... or such higher level official as the Secretary may designate.” The Tax Court (Judge Cohen) refused to address this argument on the basis that it was untimely because the taxpayer had raised it for the first time post-trial. In an opinion by Judge Wesley, the Second reversed the Tax Court’s ruling on the penalty issue. (The Second Circuit affirmed the Tax Court’s ruling that the $2 million payment was subject to self-employment tax and vacated its ruling that it had no jurisdiction to consider the increased deficiency in income tax asserted by the IRS. In light of the taxpayer’s concession that the $2 million was includable in gross income, the Second Circuit remanded with instructions to uphold the additional income tax deficiency.) The Second Circuit found the view of the majority in Graev on the penalty issue unpersuasive and sided with the dissenting judges in Graev. The court focused on the language of § 6751(b) and concluded that it is ambiguous regarding the timing of the required supervisory approval of a penalty. Because of this ambiguity, the court examined the statute’s legislative history and concluded that Congress’s purpose in enacting the provision was “to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle.” That purpose, the court reasoned, undercuts the Graev majority’s conclusion that approval of the penalty can take place at any time, even just prior to assessment. The court held “that § 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty.” Further, the court held “that compliance with § 6751(b) is part of the Commissioner’s burden of production and proof in a deficiency case in which a penalty is asserted. ... Read in conjunction with § 7491(c), the written approval requirement of § 6751(b)(1) is appropriately viewed as an element of a penalty claim, and therefore part of the IRS’s prima facie case.”

4. Return preparers need to be extra careful with not only the earned income tax credit, but also with the child tax credit, additional child tax credit, and the American Opportunity Tax Credit. T.D. 9799, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 81 F.R. 87444 (12/5/16). The Treasury Department and the IRS have issued proposed and temporary regulations that amend Reg. § 1.6695-2 to implement changes made by the Protecting Americans from Tax Hikes Act of 2015. These changes extend the § 6695(g) preparer due diligence requirements to returns or claims for refund including claims of the child tax credit (CTC), additional child tax credit (ACTC), and American Opportunity Tax Credit (AOTC), in addition to the earned income credit (EIC). As a result of these changes, one return or claim for refund may contain claims for more than one credit subject to the due diligence requirements. Each failure to comply with the due diligence requirements set forth in the regulations results in a penalty, and therefore more than one penalty could apply to a single return or claim for refund. Examples in the temporary regulations illustrate how multiple penalties could apply when one return or claim for refund is filed. Revisions to Form 8867 have been made for 2016 so that it is a single checklist to be used for all applicable credits. The temporary regulations are effective on 12/5/16.

5. A de minimis safe harbor permits payors to avoid penalties for incomplete or incorrect information returns and payee statements without correcting them unless the payee elects for the safe harbor not to apply. Notice 2017-9, 2017-4 I.R.B. 542 (1/4/17). Section 6721 imposes penalties for failure to timely file information returns or failure to include complete or correct information on such returns. Section 6722 imposes penalties for
similar failures with respect to furnishing payee statements. The penalties are reduced if the failures are corrected within 30 days of the date prescribed for filing the return or furnishing the statement. Both provisions contain an exception for de minimis failures under which the penalties do not apply if a failure to provide complete or correct information is corrected on or before August 1 of the calendar year in which the return or statement is due and the number of information returns or payee statements otherwise subject to penalties does not exceed the greater of 10 or one-half of 1 percent of the total number of information returns or payee statements the person is required to file during the calendar year. Section 202 of the Protecting Americans from Tax Hikes Act of 2015 amended §§ 6721 and 6722 to provide a safe harbor with respect to the de minimis exception. Under the safe harbor, an error on an information return or payee statement does not need to be corrected to avoid a penalty if the error relates to an incorrect dollar amount and differs from the correct amount by no more than $100 ($25 with respect to an amount of tax withheld). Sections 6721(c)(3)(B) and 6722(c)(3)(B) provide that the safe harbor does not apply if a payee makes an election that the safe harbor not apply. Thus, if a payee makes this election, the error must be corrected to avoid penalties. The notice (1) provides the requirements for making the election, (2) clarifies that the de minimis error safe harbor does not apply in the case of an intentional error or if a payor fails to file an information return or furnish a payee statement, and (3) requires payors to retain certain records. The notice also solicits comments regarding the rules contained in the notice and regarding any potential abuse of the de minimis error safe harbor. Generally, the payee must make the election using any reasonable method prescribed by the payor (or, if there is no prescribed method, in writing), include information specified in the notice such as the payee’s name, address and taxpayer identification number, and make the election with respect to payee statements required to be furnished in the calendar year in which the payee makes the election (or alternatively, with respect to payee statements required to be furnished in the calendar year of the election and succeeding calendar years). The notice applies with respect to information returns required to be filed, and payee statements required to be furnished, after 12/31/16. The notice provides that regulations incorporating the rules set forth in the notice will be issued to implement the de minimis error safe harbor and the payee election. To the extent the regulations incorporate the rules set forth in the notice, the regulations will be effective retroactively to the effective date of the notice. Although the notice does not impose a requirement for payors to notify payees regarding the de minimis error safe harbor and the available election, the regulations are expected to impose this requirement.

6. Better be careful who you hire as CFO, and raise all your arguments against liability as a responsible person at the summary judgment stage, not afterwards. McClendon v. United States, 119 A.F.T.R. 2d 2017-1037 (S.D. Tex. 3/6/17). The government successfully established through a motion for summary judgment that the taxpayer, a physician, was liable under § 6672 for a $4.3 million penalty equal to the amount of unpaid federal employment taxes owed by his medical practice. The CFO he had hired had embezzled funds and ultimately pleaded guilty to felony counts of theft. When the taxpayer learned of the unpaid taxes, he made a loan to the practice to allow it to make payroll, and these funds went to the employees rather than the government. The government used this preferential payment as the basis for establishing that the taxpayer had willfully violated his duty to pay the taxes due. The taxpayer moved for reconsideration and argued that his liability should be limited to the $100,000 preferential payment that was the basis for his liability. The court rejected this argument for two reasons. First, the taxpayer had failed to raise it in response to the government’s motion for summary judgment. Second, even if he had raised it in a timely manner, the taxpayer had failed to meet his burden to prove the absence of funds available to pay the taxes due:

At the summary judgment stage, as now, Dr. McClendon did not try to prove up the funds available to [the practice] or show that whatever funds existed were encumbered so that he had no obligation to pay them to the IRS. Instead, he effectively argues that, at summary judgment, it was the government’s burden to
demonstrate his liability for each dollar of the penalty. Not so. Dr. McClendon was presumptively liable for the balance of the IRS penalty assessed against him. The government moved for summary judgment and argued that the evidence did not create a genuine factual dispute material to deciding whether the IRS penalty was properly assessed. That discharged the government’s summary judgment burden. Dr. McClendon, who would bear the burden at trial, then had the burden to submit or identify record evidence showing that he was not liable.

B. Discovery: Summonses and FOIA

1. In this case a not-for-profit corporation is treated the same as a for-profit corporation. Maimonides Medical Center v. United States, 809 F.3d 85 (2d Cir. 12/18/15). In an opinion by Judge Lynch, the Second Circuit held that the lower interest rate that under § 6621(a)(1) applies to a refund for an overpayment of taxes due to a corporation applies to not-for-profit corporations as well as to for-profit corporations.

   a. The Sixth Circuit agrees. United States v. Detroit Medical Center, 118 A.F.T.R.2d 2016-5530 (6th Cir. 8/12/16). The IRS refunded FICA taxes paid by the plaintiff, a not-for-profit corporation, for periods prior to 4/1/05 following the IRS’s ruling that medical residents were eligible for the student exemption from FICA taxes. The IRS paid interest on the employer portion of the FICA taxes at the statutory rate provided by § 6621(a)(1) for corporations (the federal short-term rate plus 2 percentage points, reduced to 0.5 percentage points to the extent the overpayments exceed $10,000). The plaintiff asserted that, because it is a nonprofit corporation, it should not be treated as a corporation for this purpose. Instead, it asserted, it was entitled to interest at the higher statutory rate provided for non-corporate taxpayers (the federal short-term rate plus 3 percentage points). According to the plaintiff, it was entitled to additional interest of approximately $9.1 million. In an opinion by Judge Sutton, the Sixth Circuit held that nonprofit corporations are “corporations” for purposes of determining the rate of interest on overpayments. Accordingly, the court affirmed the District Court’s grant of the government’s motion for summary judgment.

   b. Will the Seventh Circuit jump on the bandwagon? Medical College of Wisconsin Affiliate Hospitals, Inc. v. United States, 118 A.F.T.R.2d 2016-5798 (E.D. Wis. 9/14/16). In a case raising the same issue, the United States District Court for the Eastern District of Wisconsin (Judge Clevert) concluded that a nonprofit corporation is the statutory rate provided by § 6621(a)(1) for corporations. The court’s decision is appealable to the Seventh Circuit.

2. Who will be looking at the information your client provided in response to a summons and asking your client questions during the summons interview? It might not be an IRS employee. T.D. 9778, Participation of a Person Described in Section 6103(n) in a Summons Interview Under Section 7602(a)(2) of the Internal Revenue Code, 81 F.R. 45409 (7/14/16). The Treasury Department and the IRS have finalized, with only one minor change, proposed and temporary regulations under § 6103(n) (T.D. 9669, Participation of a Person Described in Section 6103(n) in a Summons Interview Under Section 7602(a)(2) of the Internal Revenue Code, 79 F.R. 34625 (6/18/14)). Section 6103(n) and Reg. § 301.6103(n)-1(a) permit the disclosure of returns and return information to any person for purposes of tax administration to the extent necessary in connection with the acquisition of property or certain services (such as processing, storage and reproduction) related to returns or return information. The final regulations clarify that such persons with whom the IRS or Chief Counsel contracts for services may receive and review books, papers, records, or other data produced in compliance with [a] summons [issued by the IRS] and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of the witness summoned by the IRS to provide testimony under oath.

The final regulations state that full participation in an interview includes “being present during summons interviews; questioning the person providing testimony under oath; and asking a summoned person’s representative to clarify an objection or assertion of privilege.” The final regulations apply to summons interviews conducted on or after 7/14/16, and the temporary
regulations, which set forth the same rule, apply to summons interviews conducted on or after 6/18/14.

- Following the issuance of proposed and temporary regulations in 2014, the Tax Section of the State Bar of Texas submitted comments on the proposed regulations in which the Tax Section recommended that Treasury remove the provision that permits persons providing services to question a witness under oath or ask the witness’s representative to clarify an objection or assertion of privilege. Removing this provision, the Tax Section stated, would “result in a more orderly proceeding and a cleaner, more comprehensible transcript of the interview” and also “avoid the unsettled question of whether a private contractor has the legal authority to examine a witness.” 2014 TNT 180-24 (9/16/14). The preamble to the final regulations responds that § 7602(a) grants the IRS broad information gathering authority and that “[n]othing in section 7602(a) prohibits participation by a contractor in a summons interview, nor does it prescribe procedures that the IRS must follow during the summons interview.”

C. Litigation Costs

1. Attorneys, don’t count on asserting a claim for administrative costs under § 7430 to recover fees not paid by the client. Only a party to the underlying proceeding can be a “prevailing party” entitled to administrative costs. Greenberg v. Commissioner, 147 T.C. No. 13 (11/9/16). The petitioner, an attorney, was owed fees for representing a client before the IRS. His client agreed that the attorney would receive any administrative fees awarded under § 7430. The petitioner first submitted to the IRS a letter requesting administrative costs on behalf of his client, but later submitted another letter requesting the award on his own behalf. After a conference with IRS Appeals, the IRS denied the request. In the Tax Court, the attorney originally argued that the client had assigned to him the right to pursue the award and that he therefore had the right to seek attorney’s fees on his own behalf. He later conceded that the Anti-Assignment Act bars the assignment of a legal suit against the U.S. government and argued instead that he was pursuing the claim as it related to his own rights and not on behalf of his former client. The Tax Court (Judge Pugh) held that it lacked jurisdiction to review the IRS’s denial of the application for administrative costs. The court reviewed the statutory language and legislative history of § 7430 as well as judicial precedent interpreting it and concluded that, to be a “prevailing party” within the meaning of § 7430, a person must be a party to the underlying administrative proceeding. The attorney in this case was not a party to the underlying administrative proceeding and therefore was not the proper party to file a Tax Court petition. Accordingly, the court granted the government’s motion to dismiss for lack of jurisdiction.

D. Statutory Notice of Deficiency

1. Rumors of the death of tax exceptionalism are greatly exaggerated. A notice of deficiency need not comply with the APA’s requirement that an agency provide reasoned explanation for its action. QinetiQ US Holdings, Inc. v. Commissioner, 845 F.3d 555 (4th Cir. 1/6/17), aff’g T.C. Memo. 2015-123 (7/2/15). In 2002, an S corporation issued stock to two individuals. The stock was subject to the terms of a shareholders agreement that restricted transfers of the shares and gave the corporation the option to purchase the shares upon the executive’s death, disability or termination of employment. The purchase price varied based on the individuals’ length of employment and the event that triggered the option to purchase. The corporation terminated its S election effective in 2007 and, in 2008, was acquired by merger into QinetiQ US Holdings, Inc., the taxpayer in this case. Immediately prior to the merger, the acquired corporation waived its rights with respect to stock transfer restrictions or partially vested stock. In its taxable year ending 3/31/09, the taxpayer (the acquiring corporation) deducted $117.7 million—the value of the stock that had been transferred to one of the individuals in 2002—as wages pursuant to § 83(h). The taxpayer’s position was that the transfer of stock had been nontransferable and subject to a substantial risk of forfeiture until 2008. The IRS issued a notice of deficiency stating “that the IRS had determined that QinetiQ ‘ha[d] not established that [it was] entitled’ to a deduction ‘under the provisions of [26 U.S.C.] § 83,’ and that QinetiQ’s taxable income for the year thereby was increased by ‘$117,777,501.’” The notice of deficiency provided no further explanation. The Tax Court (Judge Goeke) held that the
taxpayer was not entitled to the deduction because the stock had not been transferred in connection with the performance of services as required by § 83 and that, even if it had been, the stock was not subject to a substantial risk of forfeiture. In an opinion by Judge Keenan, the Fourth Circuit affirmed. The Fourth Circuit first addressed the taxpayer’s argument that the notice of deficiency was invalid because it was a final agency action that failed to provide a reasoned explanation for the agency’s decision, as required by the U.S. Supreme Court’s interpretation of the Administrative Procedure Act in FCC v. Fox Television Stations, Inc., 556 U.S. 502 (2009). The Fourth Circuit rejected this argument because it failed to take into account “the unique system of judicial review provided by the Internal Revenue Code for adjudication of the merits of a Notice of Deficiency.” Some agency-specific statutes, the court reasoned, “provide materially different procedures for judicial review that predate the APA’s enactment.” The Internal Revenue Code’s authorization of de novo review of a notice of deficiency in the Tax Court is one example of this kind of statute. In light of this, the court concluded:

the APA’s general procedures for judicial review, including the requirement of a reasoned explanation in a final agency decision, were not intended by Congress to be superimposed on the Internal Revenue Code’s specific procedures for de novo judicial review of the merits of a Notice of Deficiency.

The Court also rejected the taxpayer’s argument that the notice of deficiency was insufficient to satisfy the requirement of § 7522(a) that the notice “describe the basis for, and identify the amounts (if any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice.” After reviewing situations in which courts had and had not viewed flaws in notices of deficiency as rendering them invalid, the court held that the notice of deficiency issued to the taxpayer had satisfied the basic requirements of the statute. Finally, the court affirmed the Tax Court’s holding that the stock issued by the taxpayer had not been subject to a substantial risk of forfeiture, but declined to address whether it had been transferred in connection with the performance of services.

2. This case might raise more questions than it answers. A notice of deficiency that erroneously set forth a deficiency of zero was a valid notice of deficiency. Dees v. Commissioner, 148 T.C. No. 1 (2/2/17). The taxpayer claimed on his 2014 federal income tax return a refundable premium tax credit pursuant to § 36B, which the IRS disallowed. The IRS issued a notice of deficiency that stated: “We determined that there is a deficiency in your income tax which is listed above.” Above that language, the notice listed the deficiency as zero. The attached computation pages decreased refundable credits but erroneously computed a bottom-line deficiency of zero. In one place, the notice of deficiency stated “A decrease to refundable credit results in a tax increase.” The taxpayer filed a petition in the Tax Court in response to the notice of deficiency to challenge the disallowance of the credit. The court ordered the IRS to explain whether the deficiency was zero and subsequently issued an order to show cause why the case should not be dismissed for lack of jurisdiction on the ground that the IRS had failed to determine a deficiency. The IRS explained the zero amount as a clerical error. The Tax Court, in a reviewed opinion (7-3-7) by Judge Buch, held that the notice of deficiency was valid and that the court therefore had jurisdiction over the case. The court reviewed its prior decisions regarding the validity of notices of deficiency and framed the analysis as follows:

In the holdings of these cases we see a two-pronged approach to the question of the validity of the notice of deficiency. First, we look to see whether the notice objectively put a reasonable taxpayer on notice that the commissioner determined a deficiency in tax for a particular year and amount. If the notice, viewed objectively, sets forth this information, then it is a valid notice. ... Accordingly, if the notice is sufficient to inform a reasonable taxpayer that the Commissioner has determined a deficiency, our inquiry ends there; the notice is valid. But what if, as here, the notice is ambiguous? Then our caselaw requires the party seeking to establish jurisdiction to establish that the Commissioner made a determination and that the taxpayer was not misled by the ambiguous notice.
Elsewhere in its opinion, the court characterized the analysis of an ambiguous notice as looking “beyond the notice to determine whether the Commissioner made a determination and whether the taxpayer knew or should have known that the Commissioner determined a deficiency.” In this case, the court concluded, although the notice of deficiency was ambiguous, the IRS had established that it had determined a deficiency and that the taxpayer was not misled by the notice. As evidence that the taxpayer was not misled, the court highlighted the fact that the taxpayer had filed a Tax Court petition, which made clear that the taxpayer understood that the IRS had disallowed his refundable credit.

- In a concurring opinion, Judge Marvel, joined by Judge Paris, expressed concern with the analysis in the court’s opinion. Judge Marvel disagreed with the proposition that the court’s prior decisions “support[] a test that looks, in part, to whether the taxpayer knew or should have known that the Commissioner determined a deficiency or was misled.” References in prior decisions to a taxpayer’s knowledge or being misled, she stated, were dicta that should not be elevated to a test. “The opinion of the Court has concluded, on the basis of the record as a whole, that, although the notice of deficiency was ambiguous, respondent determined an income tax deficiency with respect to petitioner and the notice is valid. No other analysis is needed or should be required.”

- In a lengthy concurring opinion, Judge Ashford argued that the relevant statutory provisions, §§ 6212, 6213 and 6214, do not support the analysis in the court’s opinion and instead dictate that the court’s jurisdiction depends on the issuance of a notice of deficiency, but does not depend on the notice’s contents. Judge Ashford distinguished between the IRS’s determination of a deficiency and its issuance of the notice of deficiency: “the notice of deficiency is a predicate for our jurisdiction, but our jurisdiction does not derive from or attach to the notice of deficiency; our jurisdiction is instead over the Commissioner’s determination that there is a deficiency.” Finally, Judge Ashford expressed the view that the appropriate remedy for a notice of deficiency with inadequate information is not to decline jurisdiction over the case, but to shift to the IRS the burden of proof on any matter not reflected in the notice or stated incorrectly in the notice. “In short, I believe we can exercise jurisdiction over this case within the statutory confines Congress established … .”

- Judge Foley wrote a dissenting opinion joined by six other judges (Judges Colvin, Vasquez, Gale, Goeke, Gustafson, and Morrison). The dissenting opinion takes the position that the notice of deficiency did not fairly advise the taxpayer that the IRS had determined a deficiency of a specific amount, and therefore was invalid.

- Judge Gustafson wrote a separate dissenting opinion joined by five other judges (Judges Colvin, Foley, Vasquez, Goeke, and Morrison) to express his disagreement with the statement in the court’s opinion that the notice in this case was not a $0 deficiency notice because the attachments to the notice informed the taxpayer that he had a decrease to refundable credits, which results in a tax increase. After discussing the statutory definition of a deficiency, Judge Gustafson concluded: “If the difference between the tax imposed and the ‘excess’ defined in section 6211(a) and (b) is zero, then by definition there is no deficiency. A notice that reports such a zero is not a notice of deficiency; it is a notice of no deficiency.” Because the IRS had not mailed a notice of deficiency, he reasoned, the case should be dismissed for lack of jurisdiction.

E. Statute of Limitations

1. Veterans have extra time to claim refunds for taxes improperly withheld from amounts received for combat-related injuries. The Combat-Injured Veterans Tax Fairness Act of 2016 (2016 CIVTFA), Pub. L. No. 114-292, was signed by the President on 12/16/16. Section 104(a)(4) and (b) exclude from gross income amounts received as a pension, annuity, or similar allowance for a combat-related injury. In *St. Clair v. United States*, 778 F. Supp. 894 (E.D. Va. 1991), the court held that a lump sum disability-related severance payment received by a veteran was excluded from the recipient’s gross income under § 104(a)(4). Despite these authorities, since 1991, the Department of Defense has withheld taxes from severance pay for wounded veterans. The 2016 CIVTFA directs the Secretary of Defense to ensure that taxes are not withheld prospectively. In addition, the legislation directs the Secretary of Defense,
within one year of the date of enactment, to identify all severance payments from which taxes were improperly withheld, notify each recipient of the improper withholding, and provide each recipient with instructions on filing amended returns to recover these amounts. The legislation extends the limitations period of § 6511(a) on filing claims for refund to the date that is one year after the required notification of improper withholding and eliminates the restriction of § 6511(b)(2) that would normally apply on the amount of tax recoverable.

F. Liens and Collections

1. And the court says the IRS’s “boilerplate” assertion of frivolity wasn’t very funny. Ryskamp v. Commissioner, 797 F.3d 1142 (D.C. Cir. 8/14/15). The taxpayer owed unpaid income taxes for several years and did not respond to the IRS’s demand for payment. The taxpayer requested a § 6330 CDP hearing, but the IRS denied him a CDP hearing based on its unexplained determination that all the reasons he gave for requesting a hearing were frivolous and contended that its frivolousness determination was not subject to judicial review. (Section 6330(g) provides that if any “portion of a request for a hearing” is frivolous or reflects the taxpayer’s desire to delay or impede the administration of the federal tax laws, the Appeals Office may treat such portion as if it were never submitted, and it “shall not be subject to any further administrative or judicial review.”) The Tax Court held that it had jurisdiction to review whether the IRS correctly treated the taxpayer’s arguments as frivolous, and the D.C. Court of Appeals, in a 2-1 opinion by Judge Pillard, affirmed the jurisdictional issue, as well as the Tax Court’s holding that the IRS’s “boilerplate letter” rejecting the taxpayer’s arguments as frivolous, but “in which there was no statement . . . as to why [his] reasons for the request . . . were illegitimate,” was inadequate.

Our reading of the statutory language respects subsection (g)’s limitation on administrative and judicial review. As we read it, subsection (g) precludes the tax court from reaching the merits of a purportedly frivolous position. ... Instead, the tax court’s review is limited to assessing whether the Service has adequately identified why it deems the taxpayer’s request, or portions thereof, to be frivolous, and whether that frivolousness assessment is facially plausible. ... That limited review provides a safeguard against the risk that the Service may have misconstrued or inadvertently overlooked a non-frivolous, i.e. plausible or potentially meritorious, request. ... The letter merely included a bullet point list of all of the possible reasons the Service could find a request to be frivolous and did not correlate them with any aspects of Ryskamp’s request. Such a list provides the taxpayer with little guidance as to how to proceed.

Nevertheless, after the Tax Court remanded, the Appeals Office had held a CDP hearing, and the Tax Court held that the IRS did not abuse its discretion in concluding in that CDP hearing that it could proceed with collection. That holding too was affirmed, so the taxpayer lost.

- But perhaps the IRS needs to rethink its form letters.

a. In light of Ryskamp, IRS Chief Counsel attorneys are advised not to contest in the Tax Court and the D.C. Circuit the Tax Court’s jurisdiction to review the IRS’s denial of CDP hearing requests as frivolous, but Counsel will advise the Department of Justice to continue to pursue the issue in other Circuits. Chief Counsel Notice CC-2016-008 (4/4/16) (available at https://perma.cc/LT77-GDZS). This Chief Counsel Notice states that “Counsel continues to maintain the position that the Tax Court lacks jurisdiction to review a petition filed from the denial of a hearing request as frivolous under section 6330(g).” Further, the Chief Counsel disagrees with the holding of Ryskamp that IRS “Appeals must articulate the bases of its denial under section 6330(g) by explaining why each argument of the taxpayer is not proper.” Nevertheless, because challenging in the Tax Court and the D.C. Circuit the Tax Court’s jurisdiction “would be a waste of Counsel’s resources,” the Chief Counsel Notice modifies the current litigating guidelines. Under the revised guidelines, if a taxpayer challenges in the Tax Court the denial of a CDP hearing as frivolous under § 6330(g), and if Chief Counsel attorneys determine that the CDP hearing request should not have been denied in its entirety because the taxpayer raised at least one legitimate issue, then they should not file a motion to dismiss, but
instead should file a motion to remand the case to IRS Appeals for a hearing addressing the legitimate issues and the issuance of a notice of determination. If instead Chief Counsel attorneys determine that a CDP hearing was properly denied, then they should file a motion to dismiss for lack of jurisdiction (in reliance on *Buczek v. Commissioner*, 143 T.C. 301 (2013)), a motion to dismiss for failure to state a claim, or a motion for summary judgment, each of which should explain why the taxpayer’s arguments meet the criteria in § 6702(b)(2)(A) so as to justify the IRS’s denial of the hearing. The Chief Counsel Notice adds that, in Tax Court cases that are appealed to Circuits other than the D.C. Circuit, Counsel will advise the Department of Justice to contest the Tax Court’s jurisdiction to review IRS denials of CDP hearing requests as frivolous pursuant to § 6330(g).

2. According to the Eleventh Circuit, the IRS is required to make a pre-assessment determination of a taxpayer’s liability as a responsible person under § 6672 when the taxpayer submits a protest, and its failure to do so might render the assessment invalid. *Romano-Murphy v. Commissioner*, 816 F.3d 707 (11th Cir. 3/7/16), vacating and remanding T.C. Memo. 2012-330 (11/29/12). The taxpayer served as the chief operating officer of a healthcare staffing business. The IRS sent to her a Letter 1153 (notice of proposed assessment) informing her that the IRS intended to hold her responsible for a penalty equal to more than $346,000 of the business’s unpaid employment taxes pursuant to § 6672(a). The taxpayer submitted a written protest and requested a conference with IRS Appeals. Due to an unexplained error, the IRS never forwarded the protest to IRS Appeals and the taxpayer was not provided with a pre-assessment conference or a final administrative determination as to her protest. Instead, the IRS assessed the tax and issued a notice of intent to levy and notice of federal tax lien, in response to which the taxpayer requested a collection due process hearing. During the CDP hearing, the IRS Appeals Office observed that the taxpayer had not had a pre-assessment opportunity to contest her liability and therefore conducted a post-assessment review of the issues the taxpayer had raised in her protest. Following this review, the IRS issued a notice of determination sustaining the proposed collection. The taxpayer sought review in the Tax Court, which sustained the IRS’s determination. The taxpayer moved to vacate on the ground that the IRS can collect a tax only after a valid assessment, and that the assessment in her case was invalid because the IRS had failed to give her a pre-assessment hearing and determination when she filed her timely protest. The Tax Court (Judge Morrison) concluded that, notwithstanding the IRS’s failure to make a pre-assessment determination of liability under § 6672(a) in response to the taxpayer’s protest, § 6672 did not prohibit the IRS’s assessment. The Tax Court accordingly denied the taxpayer’s motion to vacate. In an opinion by Judge Jordan, the Eleventh Circuit held that the IRS erred in failing to make a pre-assessment determination of the taxpayer’s liability under § 6672(a) in response to her protest. The Eleventh Circuit vacated the Tax Court’s judgment and remanded for a determination whether the IRS’s error was harmless or instead rendered the assessment invalid (or required some lesser form of corrective action). In reaching its conclusion that the IRS was required to make a pre-assessment determination of liability in response to the taxpayer’s protest, the court relied on several sources of authority. The court first concluded that § 6672(b)(3)—which provides that, “if there is a timely protest of the proposed assessment,” the period of limitations on assessment shall not expire before “the date 30 days after the Secretary makes a final administrative determination with respect to such protest”—contemplates a pre-assessment determination of liability (and notice of such determination to the taxpayer) if a timely protest has been filed. The court therefore rejected the IRS’s argument “that it may simply ignore, disregard, or discard a taxpayer's timely protest to a § 6672(b) pre-assessment notice if it so chooses.” Assuming for the sake of argument that the language of the statute is ambiguous, the court reviewed the relevant regulations and concluded that Reg. §§ 301.7430-3(d) and 301.6320-1(e)(4) “require the IRS to make a pre-assessment determination (though not necessarily through the provision of a hearing) about a taxpayer’s § 6672(a) liability when timely protest is made.” These regulations, the court concluded, are entitled to *Chevron* deference and are binding on the government as well as the taxpayer. Finally, the court regarded Reg. § 601.106(a)(1)(iv) and relevant provisions of the Internal Revenue Manual as persuasive authority that supported its conclusion.
3. Does the date on the notice or the date on the envelope control when the period for responding begins to run? Weiss v. Commissioner, 147 T.C. No. 6 (8/17/16). In this collection due process case the taxpayer sought review of the IRS’s determination to uphold a notice of intent to levy. Before the IRS may levy against a taxpayer’s property, it must provide written notice of the proposed levy and inform the taxpayer of his right to a CDP hearing. Section 6330(a)(2) requires that a levy notice must be sent or delivered to the taxpayer “not less than 30 days before the day of the first levy,” and § 6330(a)(3)(B) requires the notice to inform the taxpayer in simple and nontechnical terms of his right “to request a hearing during the 30-day period” specified in § 6330(a)(2). An IRS Revenue Officer attempted to deliver to the taxpayer in person a Final Notice of Intent to Levy, but was deterred by a dog blocking the driveway. The Revenue Officer chose instead to mail the notice by certified mail two days later without generating a new notice. The taxpayer argued that the period of limitations on collection of these liabilities expired in July 2009 based on the contention that he intentionally filed his request for a CDP hearing one day late, and thus was entitled only to an “equivalent hearing” rather than to the CDP hearing that the IRS afforded him. If the taxpayer’s contentions were correct, the period of limitations on collection would not have been suspended during the CDP process, and his tax liabilities would appear to have been uncollectible. The Tax Court (Judge Lauber) held that when the date appearing on a levy notice is earlier than the date of mailing, the 30-day period prescribed by § 6330(a)(2) and (3)(B) is calculated by reference to the date of mailing. The statutory directive that levy and lien notices should be drafted “in simple and nontechnical terms” does not require invalidation of a levy notice when there is a mismatch between the letter date and the mailing date. On the facts of the case, the taxpayer’s request for a CDP hearing was timely because he mailed his Form 12153 to the IRS, and under §§ 7502 and 7503 it was deemed received by the IRS, within 30 days of the IRS’s mailing of the levy notice, even though it was mailed more than 30 days after the date on the notice itself. Accordingly, the period of limitations on collection was suspended pursuant to § 6330(e)(1) when the taxpayer timely requested a CDP hearing.

4. The taxpayer may have been misled by a scam promising huge returns from African diamonds, but prevailed in arguing that the IRS’s failure to consider a collection alternative in a CDP hearing was an abuse of discretion. Leslie v. Commissioner, T.C. Memo. 2016-171 (9/14/16). In connection with divorce proceedings, the taxpayer entered into a marital separation agreement with her husband that entitled her to 10 percent of whatever fee her husband, an attorney, would receive from representing the University of California Regents as plaintiffs in a class action against Enron. Her former husband ultimately received a fee of more than $50 million, and the taxpayer became entitled to $5.5 million. The Tax Court (Judge Holmes) held that the $5.5 million was taxable alimony rather than a nontaxable property settlement, but concluded that the taxpayer had not actually or constructively received this amount in 2009 (or any other years before the court). The court also concluded that the taxpayer was eligible for a $400,000 theft loss deduction for a payment “to an internet scamster who claimed he would invest it for her in an African diamond scheme but who made off with the money,” and that she was subject to failure-to-file penalties for some years despite serious mental illness. The opinion is significant, however, for its holding on the IRS’s ability to raise new arguments to justify its rejection of collection alternatives in a CDP hearing. After the IRS filed a notice of federal tax lien and issued a final notice of intent to levy, the taxpayer requested a CDP hearing and, in that hearing, both sought to contest the underlying tax liability and requested an installment agreement. In the CDP hearing, the taxpayer submitted amended returns for two of the years involved and also submitted a complete Form 433-A complete with all supporting documentation, except that she submitted information regarding life and health insurance premiums for only three months rather than for six months as the settlement officer had requested. Although the settlement officer generated an allowable expense worksheet showing that the taxpayer could afford a monthly payment of $5,500, the IRS issued a notice of determination upholding the collection action. The notice of determination did not analyze collection alternatives. In the Tax Court, the IRS argued that the settlement officer acted within her discretion in denying collection alternatives because the taxpayer had failed to supply the
requested additional information regarding health and life insurance premiums. The court applied the doctrine of *Securities and Exchange Commission vs. Chenery Corp.*, 332 U.S. 194 (1947), 318 U.S. 80 (1943), which it described as “an administrative law principle that says a court, in reviewing a determination which an ‘administrative agency alone is authorized to make, must judge the propriety if such an action solely on the grounds invoked by the agency.’” The notice of determination did not cite the lack of health and life insurance information as a reason to deny collection alternatives. Because the settlement officer had failed to consider collection alternatives despite having all information necessary to do so, the court held that the failure to consider collection alternatives was an abuse of discretion. The court remanded to the IRS Appeals Office to hold a supplemental hearing.

- This case illustrates that the Tax Court applies the *Chenery* doctrine in cases in which the IRS has issued a notice of determination following a CDP hearing. In contrast, the Tax Court (Judge Gustafson) recently held in *Ax v. Commissioner*, 146 T.C. No. 10 (4/11/16) that neither the Administrative Procedure Act (5 U.S.C. §§ 701-706 (judicial review)) nor the *Chenery* doctrine bar the IRS from raising new grounds to support a notice of deficiency beyond those grounds originally stated in the notice.

5. **It’s going to cost more to submit that offer in compromise.** REG-108934-16, User Fees for Offers in Compromise, 81 F.R. 70654 (10/13/16). The Treasury Department and the IRS have issued proposed regulations that would significantly increase the user fee for processing an offer in compromise. Currently, the general user fee for an offer in compromise is $186. However, no fee is charged for an offer in compromise based solely on doubt as to liability, or if the taxpayer is a low income taxpayer (defined as a taxpayer who has income at or below 250 percent of the federal poverty guidelines). Under the proposed regulations, the general fee for an offer in compromise would increase to $300, but no change would be made for offers in compromise based on doubt as to liability or those submitted by a low income taxpayer. The preamble to the proposed regulations provides a great amount of detail on how the increased user fee was determined, including the cost of the services provided. These regulations are proposed to be effective for offers in compromise submitted on or after 2/27/17.

6. **The fees for installment agreements are going up!** T.D. 9798, User Fees for Installment Agreements, 81 F.R. 86955 (12/2/16). The Treasury Department and the IRS have finalized without change proposed regulations (REG-108792-16, User Fees for Installment Agreements, 81 F.R. 56543 (8/22/16)) that significantly increase the user fees for entering into an installment agreement. Prior to the effective date of these regulations: (1) the general user fee for an installment agreement is $120, which is reduced to $52 for a direct debit installment agreement that permits the IRS to withdraw the installment payments from the taxpayer’s bank account; (2) the user fee is $43 for a low income taxpayer, defined as a taxpayer who has income at or below 250 percent of the federal poverty guidelines; and (3) the fee for restructuring or reinstating an installment agreement is $50. Under the final regulations, the fee for low income taxpayers remains the same, but the general fee increases to $225, the direct debit fee increases to $107, and the fee for restructuring or reinstating an installment agreement increases to $89. In addition, the regulations establish two new user fees for online payment agreements. The general user fee for a taxpayer who sets up an installment agreement online is $149, and the fee for a direct debit online payment agreement is $31. These regulations apply to installment agreements entered into, restructured, or reinstated on or after 1/1/17.

7. **A taxpayer cannot challenge in a CDP hearing the imposition of a penalty under § 6707A for failure to report participation in a listed transaction after being provided the opportunity for a conference with IRS Appeals.** *Keller Tank Services II, Inc. v. Commissioner*, 848 F.3d 1251 (10th Cir. 2/21/17). Section 6330(c)(2)(B) permits a taxpayer to challenge the existence or amount of the taxpayer’s underlying tax liability in a CDP hearing only “if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability.” In this case, the IRS determined that the taxpayer was subject to a penalty under § 6707A for failure to report participation in a listed transaction. The taxpayer filed a protest and had a telephone conference with an IRS Appeals Officer, who decided that the penalty should be sustained. The IRS then assessed the tax
and issued a final notice of intent to levy, in response to which the taxpayer requested a CDP hearing. In the CDP hearing, the IRS Settlement Officer took the position that § 6330(c)(2)(B) precluded the taxpayer from challenging the underlying tax liability because the pre-assessment conference with IRS Appeals was an opportunity to dispute the liability within the meaning of the statute. Following the CDP hearing, the IRS issued a notice of determination upholding the collection action and the taxpayer filed a petition in the Tax Court. In an unpublished order, the Tax Court (Judge Carluzzo) granted the government’s motion for summary judgment and held that, under the relevant regulation (Reg. § 301.6330-1(e)(3), Q&A E2), which the court previously had upheld in *Lewis v. Commissioner*, 128 T.C. 48 (2007), the taxpayer’s opportunity for a conference with IRS Appeals prior to the assessment of the tax was a prior opportunity to dispute the underlying tax liability for purposes of § 6330(c)(2)(B). In an opinion by Judge Matheson, the U.S. Court of Appeals for the Tenth Circuit affirmed. Under the relevant regulation, the court explained, for taxes not subject to deficiency procedures, a prior opportunity for a pre-assessment conference with IRS Appeals is an opportunity to dispute the underlying liability that precludes a later challenge of the liability in a CDP hearing. The court assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 6330(c)(2)(B), is ambiguous, and in step two that Reg. § 301.6330-1 is a reasonable interpretation of the statute.

a. **The Fourth Circuit agrees.** *Iames v. Commissioner*, 850 F.3d 1060 (4th Cir. 3/7/17). In an opinion by Judge Wilkinson, the U.S. Court of Appeals for the Fourth Circuit reached the same conclusion as the Tenth Circuit in *Keller Tank Services, II, Inc. v. Commissioner*, 848 F.3d 1251 (10th Cir. 2/21/17), i.e., that the taxpayer’s opportunity for a conference with IRS Appeals prior to the assessment of the tax in question was a prior opportunity to dispute the underlying tax liability for purposes of § 6330(c)(2)(B). The Fourth Circuit explained:

> It is clear that the option to request a hearing with the Office of Appeals before the Commissioner assesses the tax counts as “an opportunity to dispute [one’s] tax liability.” First, taxpayers in these hearings have a genuine chance to explain why they should not be held to the amount requested by the Commissioner. Second, the Office of Appeals is an independent decisionmaker. As the Tax Court noted in *Lewis*, the law establishing Section 6330 also “mandate[d] that an independent appeals function exist within the IRS,” *Lewis*, 128 T.C. at 59, suggesting that the Office of Appeals is “more than just a rubber stamp for the Commissioner’s determinations,” *id.* at 60. Finally, the Office of Appeals conducts both the preassessment hearing and the CDP hearing. We conclude that the former precludes the latter when it comes to tax liability.

The court also addressed § 6330(c)(4), which provides in part that an issue may not be raised at a CDP hearing if “the issue was raised and considered at a previous hearing under section 6320 or in any other previous administrative or judicial proceeding” and “the person seeking to raise the issue participated meaningfully in such hearing or proceeding.” The court held that § 6330(c)(4) also barred the taxpayer from challenging his liability in the CDP hearing.

8. **The Fifth Circuit upholds an order of foreclosure and sale with respect to a residence despite an ownership interest held by the taxpayer’s children.** *United States v. Davis*, 119 A.F.T.R.2d 2017-529 (5th Cir. 3/9/17). The government successfully established in a prior proceeding in federal district court in 2008 that S.P. Davis was jointly and severally liable under § 6672 for a penalty equal to the amount of unpaid federal employment taxes owed by three medical companies that he co-owned. Mr. Davis was ordered to pay to the government $3,327 per month. When he failed to comply with the order, the government filed suit in 2012 in federal district court pursuant to § 7403 to foreclose federal tax liens on the residence that Mr. Davis owned in Louisiana as community property with his wife. His wife died intestate in 2013. As a result of her death, Mr. Davis remained the owner of 50 percent of the residence and acquired a right, known as a “usufruct” under Louisiana law, in the other 50 percent. A usufruct
is a right to enjoy property belonging to another similar to a life estate in common law jurisdictions. The two adult children of Mr. Davis and his wife each inherited a 25 percent ownership interest, known under Louisiana law as a naked ownership interest, in the portion of the property in which Mr. Davis had a usufruct. Mr. Davis moved for partial summary judgment in the District Court and argued that, if the house were sold, his two children each should be entitled to one-fourth of any sale proceeds that remain after satisfaction of a prior mortgage held by a bank, which the government conceded had priority over the federal tax lien. The District Court denied the motion and entered an order of foreclosure and sale. In a per curiam opinion, the U.S. Court of Appeals for the Fifth Circuit affirmed. The court rejected Mr. Davis’s argument that the District Court erred in failing to exercise its discretion to prohibit the sale and seizure of the residence. The court referred to United States v. Rodgers, 461 U.S. 677 (1983), in which the U.S. Supreme Court concluded that § 7403 leaves room for the exercise of reasoned discretion to decline to order a sale of the property, but cautioned that this discretion “should be exercised rigorously and sparingly, keeping in mind the Government’s paramount interest in prompt and certain collection of delinquent taxes.” In light of Mr. Davis’s failure to comply with the order to make monthly payments, the court concluded, it could not say that the District Court had committed reversible error in refusing to exercise its limited discretion. The rights of the two children in the property, the court reasoned, were inferior to the federal tax lien, which attached to the entire community property while their mother was alive. The residence was subject to seizure and sale because, under Louisiana law, which determines the property interests to which the federal tax lien attached, the tax lien in question was a separate obligation incurred during the community property regime that can be satisfied from community property even after termination of the regime.

G. Innocent Spouse

H. Miscellaneous

1. The Tenth Circuit stirs the previously muddied water on whether a late-filed return is a “return” that will permit tax debt to be discharged in bankruptcy proceedings. In re Mallo, 774 F.3d 1313 (10th Cir. 12/29/14), cert denied, 135 S. Ct. 2889 (6/29/15). In an opinion by Judge McHugh, the Tenth Circuit held, with respect to taxpayers in two consolidated appeals, that a late return filed after the IRS had assessed tax for the year in question was not a “return” within the meaning of 11 U.S.C. § 523(a) and, consequently, the taxpayers’ federal tax liabilities were not dischargeable in bankruptcy. The facts in each appeal were substantially the same. The taxpayers failed to file returns for the years 2000 and 2001. The IRS issued notices of deficiency, which the taxpayers did not challenge, and assessed tax for those years. The taxpayers subsequently filed returns, based on which the IRS partially abated the tax liabilities. The taxpayers then received general discharge orders in chapter 7 bankruptcy proceedings and filed adversary proceedings against the IRS seeking a determination that their income tax liabilities for 2000 and 2001 had been discharged. Section 523(a)(1) of the Bankruptcy Code excludes from discharge any debt for a tax or customs duty:

(B) with respect to which a return, or equivalent report or notice, if required—
(i) was not filed or given; or
(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of filing of the petition;

An unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that, for purposes of § 523(a): the term ‘return’ means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared under section 6020(a) of the Internal Revenue Code … but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code ….
The court examined a line of conflicting cases in which the courts had applied a four-factor test, commonly known as the *Beard* test (*Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986)), to determine whether a late-filed return constitutes a “return” for purposes of 11 U.S.C. § 523(a) and concluded that it did not need to resolve that issue. Instead, the court concluded that, unless it is prepared by the IRS with the assistance of the taxpayer under § 6020(a), a late return is not a “return” because it does not satisfy “the requirements of applicable nonbankruptcy law (including applicable filing requirements)” within the meaning of the language added to the statute in 2005.

- In reaching its conclusion, the Tenth Circuit agreed with the analysis of the Fifth Circuit in *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), in which the Fifth Circuit concluded that a late-filed Mississippi state tax return was not a “return” within the meaning of 11 U.S.C. § 523(a).
- The Tenth Circuit’s interpretation of 11 U.S.C. § 523(a) is contrary to the IRS’s interpretation, which the IRS made clear to the court during the appeal. The IRS’s interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10), is that “section 523(a) does not provide that every tax for which a return was filed late is nondischargeable.” However, according to the Chief Counsel Notice, a debt for tax assessed before the late return is filed (as in the situations before the Tenth Circuit in *In re Mallo*) “is not dischargeable because a debt assessed prior to the filing of a Form 1040 is a debt for which is return was not ‘filed’ within the meaning of section 523(a)(1)(B)(i).”

a. **The First Circuit aligns itself with the Fifth and Tenth Circuits and applies the same analysis to a late-filed Massachusetts state income tax return.** *In re Fahey*, 779 F.3d 1 (1st Cir. 2/18/15). In an opinion by Judge Kayatta, the First Circuit aligned itself with the Fifth and Tenth Circuits and concluded that a late-filed Massachusetts state income tax return was not a “return” within the meaning of 11 U.S.C. § 523(a). In a lengthy dissenting opinion, Judge Thompson argued that the majority’s conclusion was inconsistent with both the language of and policy underlying the statute: “The majority, ignoring blatant textual ambiguities and judicial precedent, instead opts to create a per se restriction that is contrary to the goal of our bankruptcy system to provide, as the former President put it in 2005, ‘fairness and compassion’ to ‘those who need it most.’”

b. **A Bankruptcy Appellate Panel in the Ninth Circuit disagrees with the First, Fifth, and Tenth Circuits. The Ninth Circuit now might have an opportunity to weigh in.** *In re Martin*, 542 B.R. 479 (B.A.P. 9th Cir. 12/17/15). In an opinion by Judge Kurtz, a Bankruptcy Appellate Panel in the Ninth Circuit disagreed with what it called the “literal construction” by the First, Fifth and Ninth Circuits of the definition of the term “return” in Bankruptcy Code § 523(a). The court emphasized that the meaning of the language in the unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides that “the term ‘return’ means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements),” must be determined by taking into account the context of the surrounding words and also the context of the larger statutory scheme. Taking this context into account, the court reasoned, leads to the conclusion that the statutory language does not dictate that a late-filed return automatically renders the taxpayer’s income tax liability non-dischargeable. “Why Congress would want to treat a taxpayer who files a tax return a month or a week or even a day late—possibly for reasons beyond his or her control—so much more harshly than a taxpayer who never files a tax return on his or her own behalf [and instead relies on the IRS to prepare it pursuant to § 6020(a)] is a mystery that literal construction adherents never adequately explain.” The court also rejected the IRS’s interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10) that, although not every tax for which a return is filed late is nondischargeable, a debt for tax assessed before the late return is filed (as in the situation before the court) is not dischargeable because the tax debt is established by the assessment and therefore arises before the return was filed. Instead, the court concluded that binding Ninth Circuit authority predating the 2005 amendments to Bankruptcy Code § 523(a) requires applying the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), aff’d, 793 F.2d 139 (6th Cir. 1986)) to determine
whether a late-filed return constitutes a “return” for purposes of 11 U.S.C. § 523(a). The court concluded that the Bankruptcy Court, which had held that the taxpayers’ late-filed returns were “returns” within the meaning of the statute, had relied on a version of the *Beard* test that did not reflect the correct legal standard. Accordingly, the court remanded to the Bankruptcy Court for further consideration.

c. The Eleventh Circuit declines to decide whether a late-filed return always renders a tax debt nondischargeable in bankruptcy. In re Justice, 817 F.3d 738 (11th Cir. 5/30/16). In an opinion by Judge Anderson, the Eleventh Circuit declined to adopt what it called the “one-day-late” rule embraced by the First, Fifth and Tenth Circuits because it concluded that doing so was unnecessary to reach the conclusion that the taxpayer’s federal income tax liability was nondischargeable in bankruptcy. The taxpayer filed his federal income tax returns for four tax years after the IRS had assessed tax for those years and between three and six years late. The court concluded that it need not adopt the approach of the First, Fifth and Tenth Circuits because, even if a late-filed return can sometimes qualify as a return for purposes of Bankruptcy Code § 523(a), a return must satisfy the four-factor *Beard* test (Beard v. Commissioner, 82 T.C. 766 (1984), aff’d, 793 F.2d 139 (6th Cir. 1986)) in order to constitute a return for this purpose, and the taxpayer’s returns failed to satisfy this test. One of the four factors of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Eleventh Circuit joined the majority of the other circuits in concluding that delinquency in filing a tax return is relevant to whether the taxpayer made such an honest and reasonable attempt. “Failure to file a timely return, at least without a legitimate excuse or explanation, evinces the lack of a reasonable effort to comply with the law.” The taxpayer in this case, the court stated, filed his returns many years late, did so only after the IRS had issued notices of deficiency and assessed his tax liability, and offered no justification for his late filing. Accordingly, the court held, he had not filed a “return” for purposes of Bankruptcy Code § 523(a) and his tax debt was therefore nondischargeable.

d. The Ninth Circuit holds that a taxpayer’s tax debt cannot be discharged in bankruptcy without weighing in on the issue whether a late-filed return always renders a tax debt nondischargeable. In re Smith, 828 F.3d 1094 (9th Cir. 7/13/16). In an opinion by Judge Christen, the Ninth Circuit held that the tax liability of the taxpayer, who filed his federal income tax return seven years after it was due and three years after the IRS had assessed the tax, was not dischargeable in bankruptcy. The government did not assert the “one-day-late” rule embraced by the First, Fifth and Tenth Circuits. Accordingly, the Ninth Circuit looked to its prior decision in In re Hatton, 220 F.3d 1057 (9th Cir. 2000), issued prior to the 2005 amendments to the Bankruptcy Code on which the First, Fifth and Tenth Circuits relied. In In re Hatton, the Ninth Circuit had adopted the four-factor *Beard* test (Beard v. Commissioner, 82 T.C. 766 (1984), aff’d, 793 F.2d 139 (6th Cir. 1986)) to determine whether the taxpayer had filed a “return” for purposes of Bankruptcy Code § 523(a). The fourth factor of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Ninth Circuit concluded that the taxpayer had not made such an attempt:

Here, Smith failed to make a tax filing until seven years after his return was due and three years after the IRS went to the trouble of calculating a deficiency and issuing an assessment. Under these circumstances, Smith’s “belated acceptance of responsibility” was not a reasonable attempt to comply with the tax code. The court noted that other circuits similarly had held that post-assessment filings of returns were not honest and reasonable attempts to satisfy the requirements of the tax law, but refrained from deciding whether any post-assessment filing could be treated as such an honest and reasonable attempt.

2. The Tax Court rejects the IRS’s first try at denying a whistleblower award to the guy who handed it $74 million from Wegelin & Company on a platter. Whistleblower 21276-13W v. Commissioner, 144 T.C. 290 (6/2/15). The Tax Court (Judge Jacobs) held that the fact that a whistleblower supplied information to other federal agencies, including an IRS operating division, before submitting the information to the Whistleblower...
Office on Form 211 did not, as a matter of law, render the whistleblower ineligible for an award under § 7623(b). At the time the whistleblower began cooperating with the IRS, FBI, and a United States Attorney’s office to obtain an indictment of a foreign business for assisting U.S. taxpayers to evade taxes, the whistleblower was unaware of any whistleblower award program.

“The Targeted Business was indicted, with a subsequent superseding indictment, for conspiring with U.S. taxpayers and others to hide more than $1.2 billion in secret accounts, and the income generated therefrom, from the IRS. The Targeted Business pleaded guilty, as [the whistleblower] predicted. As part of its guilty plea, the Targeted Business paid the United States approximately $74 million.” (Although the opinion refers to the “Targeted Business,” the facts recited in the opinion lead to the obvious conclusion that the “Targeted Business” was the Swiss bank Wegelin & Company.) The court rejected the IRS’s argument that a whistleblower is ineligible for a § 7623(b) award if he or she provides the information to an operating division of the IRS before submitting the information, via a Form 211, to the Whistleblower Office. Because it had rejected the claim as untimely, the Whistleblower Office did not conduct a review, investigation, or evaluation of the merits of petitioners’ claims for award. The court ordered that “the parties should have an opportunity to resolve these cases on the basis of our holding herein [and are required] to file a status report in accordance with an order to be issued.”

a. The Tax Court rejects the IRS’s second (and presumably final) attempt to avoid paying the full amount due to the whistleblower in this case. Whistleblower 21276-13W v. Commissioner, 147 T.C. No. 4 (8/3/16). Following the Tax Court’s prior order that the parties attempt to resolve their differences (144 T.C. 290 (6/2/15)), the IRS and the petitioners, a married couple, agreed that the petitioners are eligible for a whistleblower award of 24 percent of the collected proceeds (i.e., the proceeds eligible for an award), but disagreed as to the amount of the collected proceeds. The targeted taxpayer paid to the government approximately $74 million, which consisted of tax restitution ($20 million), a criminal fine ($22 million), and civil forfeitures representing fees received from U.S. clients ($32 million). The parties agreed that the tax restitution payment constituted collected proceeds, but disagreed as to whether payments of the criminal fine and civil forfeitures constituted collected proceeds. Section 7623(b)(1) provides that a whistleblower award is:

at least 15 percent but not more than 30 percent of the collected proceeds (including penalties, interest, additions to tax, and additional amounts) resulting from the action (including any related actions) or from any settlement in response to such action.

The IRS argued that the plain language of § 7623 dictates that only proceeds assessed and collected under a provision of title 26 may be used to pay a whistleblower award because § 7623 relates solely to violations of federal tax laws, and therefore criminal fines and civil forfeitures (which are not assessed under title 26) are not “collected proceeds” within the meaning of § 7623(b)(1). The IRS also argued that, if forfeitures could be used for payment of the whistleblower award, an irreconcilable conflict would be created between the whistleblower statute in title 26 and the provisions of title 42 regarding criminal fines and those of title 31 regarding civil forfeitures that specify the purposes for which moneys collected in this case under title 18 may be used. In a very thorough opinion, the Tax Court (Judge Jacobs) held that § 7623(b)(1), which “is straightforward and written in expansive terms,” does not limit “collected proceeds” to amounts assessed and collected under title 26. The court similarly rejected the IRS’s second argument, which the court characterized as arising “from a fundamental misinterpretation of the plain language of the statute.” According to the court, § 7623(b)(1) “does not refer to, or require, the availability of funds to be used in making an award.”

3. Was Dad invited for Thanksgiving dinner even though he filed a Form SS-8 asking the IRS to determine his employment status in the family business? B G Painting, Inc. v. Commissioner, T.C. Memo. 2016-62 (4/5/16). The IRS notified the taxpayer’s president that one of the taxpayer’s workers had filed a Form SS-8 asking the IRS to determine his employment status. In the taxpayer’s response, the president informed the IRS that the
worker was his father and provided other requested information. The IRS issued Letter 4991 to the worker and a Letter 4991-A to the taxpayer notifying them of its determination that the worker was an employee rather than an independent contractor. The taxpayer filed a petition in the Tax Court, and the IRS moved to dismiss for lack of jurisdiction. The Tax Court (Judge Dawson) granted the government’s motion to dismiss. “Section 7436(a) confers jurisdiction on this Court only with regard to determinations that are made by the IRS in connection with an audit of a taxpayer. Other IRS determinations of employment status that are not made as part of a taxpayer audit, including those made in the context of private letter rulings or Forms SS-8, are not subject to review by this Court under section 7436(a).” The Letter 4991 issued by the IRS, the court explained, was not a notice of determination that would confer jurisdiction on the court. Further, under the first part of the four-part test established in American Airlines, Inc. v. Commissioner, 144 T.C. 24 (2015), for determining jurisdiction under § 7436(a), the IRS must make an examination in connection with an audit. The court noted that it had previously held in Staffmore, LLC v. Commissioner, T.C. Memo. 2013-187, “that IRS review of information provided in a Form SS-8 submission is not considered an ‘audit’ or ‘examination.’”

4. Taxpayers who need to pay their taxes in cash can now do so at the same time they purchase a Slurpee. IR 2016-56 (4/6/16) (available at https://perma.cc/R5DU-HC7J). The IRS announced that individuals can now make tax payments at 7-Eleven stores without the need of a bank account or credit card. To do so, taxpayers must go through an online process, print out a payment code, and bring the code to the store. There is a $1,000 payment limit per day and a $3.99 fee per payment.

5. Only certain private delivery services provide the benefit of the “timely mailed is timely filed” rule. Notice 2016-30, 2016-18 I.R.B. 676 (4/11/16) This notice (1) updates the list of designated private delivery services set forth in Notice 2015-38, 2015-21 I.R.B. 984 (5/6/15), for purposes of the “timely mailing treated as timely filing/paying” rule of § 7502, (2) provides rules for determining the postmark date for these services, and (3) provides the address for submitting documents to the IRS with respect to an application for designation as a designated private delivery service. These changes are effective 4/11/16. Notice 2015-38, 2015-21 I.R.B. 984 (5/6/15), is modified and superseded.

6. A snowy day at the Tax Court. Guralnik v. Commissioner, 146 T.C. No. 15 (6/2/16). The taxpayer filed a petition in the Tax Court challenging the IRS’s notice of determination sustaining collection action. The taxpayer sent the petition on February 13, 2015 by Federal Express using a delivery method that did not qualify for the “timely mailed is timely filed” rule of § 7502(a). Although the petition should have been delivered on February 17, 2015, which was the deadline for filing the petition, all federal offices, including the Tax Court, were closed on that day because of a snowstorm. The petition was delivered to the court on the first day the court was open following the storm, February 18, 2015. The government moved to dismiss for lack of jurisdiction because the taxpayer did not file the petition within the 30-day period prescribed by § 6330(d). In a unanimous, reviewed opinion by Judge Lauber, the Tax Court denied the motion. The court looked to Federal Rule of Civil Procedure 6(a)(3)(A), which provides that if the clerk’s office is inaccessible on the last day for filing, then the time for filing is extended to the first day that is not a Saturday, Sunday, or legal holiday on which the clerk’s office is accessible. Although the Tax Court’s rules do not address this situation, Tax Court Rule 1(b) provides:

Where in any instance there is no applicable rule of procedure, the Court or the Judge before whom the matter is pending may prescribe the procedure, giving particular weight to the Federal Rules of Civil Procedure to the extent that they are suitably adaptable to govern the matter at hand.

The court held that, in the absence of a Tax Court Rule prescribing the procedure when the clerk’s office is inaccessible, the principles of Federal Rule of Civil Procedure 6(a)(3)(A) are “suitably adaptable to govern the matter at hand.” Accordingly, the taxpayer’s petition was timely.
7. The IRS establishes a new fast-track mediation procedure for offer-in-compromise and trust fund recovery penalty cases in the Small Business/Self-Employed division. Rev. Proc. 2016-57, 2016-49 I.R.B. 786 (11/18/16). This revenue procedure establishes a fast-track mediation procedure, known as SB/SE Fast Track Mediation—Collection (FTMC), that replaces the fast-track mediation procedure set forth in Rev. Proc. 2003-41, 2003-1 C.B. 1047. The prior fast-track mediation procedure was available to taxpayers with cases in either examination or collection, but use of the program was infrequent, especially for cases in examination after the IRS in 2011 implemented a fast-track settlement program for examination cases in the Small Business/Self Employed Division. See Announcement 2011-15, 2011-4 I.R.B. 430 (12/30/10). The new FTMC program preserves fast-track mediation for cases in collection. According to the revenue procedure, “FTMC may be used only when all other collection issues are resolved but for the issue(s) for which FTMC is being requested. The issue(s) to be mediated must be fully developed with clearly defined positions by both parties so the unagreed issues can be resolved quickly (usually within 30 or 40 calendar days).” The revenue procedure provides examples of when FTMC is and is not appropriate. For example, in OIC cases, FTMC is appropriate to determine issues such as the value of a taxpayer’s assets (including those held by third parties), and in trust fund recovery penalty cases for issues such as whether a person was required to collect, truthfully account for, and pay over income, employment or excise taxes. A request for FTMC is made after an issue has been fully developed (and before collection has made a final determination regarding the issue) by submitting Form 13369, which must be signed by both the taxpayer (or authorized representative) and the Collection Group Manager. Written summaries of both the taxpayer’s and collection’s positions must accompany the form. The request is submitted to IRS Appeals and, if the request for FTMC is approved, the case is assigned to an Appeals employee who serves as a mediator. The Appeals mediator does not have settlement authority and serves only as a facilitator. The revenue procedure notes that the prohibition on ex parte communications between Appeals and other IRS employees does not apply to communications arising in FTMC because Appeals personnel “are not acting in their traditional Appeals settlement role,” but provides that communications by either party with the Appeals mediator outside the mediation session are prohibited. The revenue procedure also provides that “[t]he parties to the mediation may not make a stenographic record, audio or video tape recording, or other transcript of the mediation session.” Following the mediation session, the Appeals mediator will prepare a brief written report. The revenue procedure is effective 11/18/16. Rev. Proc. 2003-41, 2003-1 C.B. 1047, is obsoleted.

8. The Seventh Circuit’s advice to law firms: don’t wait until the last day to file a Tax Court petition and then mail an envelope without an official postmark! Nevertheless, the petition in this case was timely. Tilden v. Commissioner, 846 F.3d 882 (7th Cir. 1/13/17), rev’g T.C. Memo 2015-188 (9/22/15). The last day for the taxpayer, who was represented by counsel, to file a Tax Court petition was April 21, 2015. A member of the law firm’s staff printed a label from Stamps.com dated April 21, 2015 and stated that she delivered the envelope to the Postal Service in Salt Lake City, Utah, on that date. The Tax Court received the petition on April 29. The Tax Court (Judge Armen) dismissed the petition as having been untimely filed by relying on Reg. § 301.7502-1(c)(1)(iii)(B)(3), which provides:

If the envelope has a postmark made by the U.S. Postal Service in addition to a postmark not so made, the postmark that was not made by the U.S. Postal Service is disregarded, and whether the envelope was mailed in accordance with this paragraph (c)(1)(iii)(B) will be determined solely by applying the rule of paragraph (c)(1)(iii)(A) of this section [regarding envelopes near U.S. postmarks].

The envelope with the taxpayer’s petition was entered into the Postal Service's tracking system for certified mail on April 23, which the Tax Court treated as a postmark and therefore the date of filing. In an opinion by Judge Easterbrook, the Seventh Circuit reversed and remanded. The regulation applied by the Tax Court, the Seventh Circuit reasoned, applies only when the envelope bears both a U.S. Postal Service postmark and a non-U.S. Postal Service postmark,
which was not the case here. In the court’s view, the Tax Court should have applied the rules of Reg. § 301.7502-1(c)(1)(iii)(B)(1)-(2), which address situations in which an envelope bears only a non-U.S. Postal Service postmark. Generally, these rules treat the date of the private postmark as the date of mailing if the item is received by the relevant agency not later than the time when a properly addressed and mailed envelope sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service. The court also held that the time limit set forth in § 6213(a) for filing a Tax Court petition is jurisdictional.

Finally, the court admonished the law firm for its handling of the situation:

[W]e have to express astonishment that a law firm (Stoel Rives, LLP, of Salt Lake City) would wait until the last possible day and then mail an envelope without an official postmark. A petition for review is not a complicated document; it could have been mailed with time to spare. And if the last day turned out to be the only possible day (perhaps the firm was not engaged by the client until the time had almost run), why use a private postmark when an official one would have prevented any controversy? A member of the firm’s staff could have walked the envelope to a post office and asked for hand cancellation. The regulation gives taxpayers another foolproof option by providing that the time stamp of a private delivery service, such as FedEx or UPS, is conclusive.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

B. Self-employment Taxes

1. Partners are self-employed, even if they are employees of a disregarded entity owned by the partnership. Self-Employment Tax Treatment of Partners in a Partnership That Owns a Disregarded Entity, T.D. 9766, 81 F.R. 26693 (5/4/16). Treasury and the IRS have issued proposed and temporary amendments to the check-the-box regulations under § 7701 clarifying that a partner in a partnership is considered self-employed even if the partner is an employee of a disregarded entity owned by the partnership. The existing regulations provide that (1) a single-member business entity that is not classified as a corporation under Reg. § 301.7701–2(b) is disregarded as an entity separate from its owner; (2) such a disregarded entity nevertheless is treated as a corporation for employment tax purposes, which means that the disregarded entity, rather than its owner, is considered to be the employer of the entity’s employees for employment taxes purposes; and (3) the rule that the disregarded entity is treated as a corporation for employment tax purposes does not apply for self-employment tax purposes. The existing regulations state that the owner of a disregarded entity that is treated as a sole proprietorship is subject to tax on self-employment income and provide an example in which the disregarded entity is subject to employment tax with respect to employees of the disregarded entity, but the individual owner is subject to self-employment tax on the net earnings from self-employment resulting from the disregarded entity’s activities. Reg. § 301.7701–2(c)(2)(iv)(C)(2), -2(c)(2)(iv)(D), Ex. The IRS’s longstanding position has been that a partner is self-employed and that any remuneration the partner receives for services rendered to the partnership are not wages subject to FICA, FUTA, and income tax withholding. Rev. Rul. 69-184, 1969-1 C.B. 256. Nevertheless, some taxpayers apparently have taken the position that, because the existing regulations do not include an example illustrating how the rules apply to a disregarded entity owned by a partnership, an individual partner in a partnership that owns a disregarded entity can be treated as an employee of the disregarded entity and therefore can participate in certain tax-favored employee benefit plans. The proposed and temporary amendments to the regulations clarify that a disregarded entity is not treated as a corporation for purposes of employing either its individual owner, who is treated as a sole proprietor, or employing an individual that is a partner in a partnership that owns the disregarded entity. Instead, the entity is disregarded as an entity separate from its owner for this purpose.

• To allow adequate time for partnerships to make necessary payroll and benefit plan adjustments, the proposed and temporary amendments apply on the later of:
(1) August 1, 2016, or (2) the first day of the latest-starting plan year following May 4, 2016, of an affected plan sponsored by a disregarded entity. An affected plan includes any qualified plan, health plan, or § 125 cafeteria plan if the plan benefits participants whose employment status is affected by these regulations.

• The proposed and temporary amendments do not address the application of Rev. Rul. 69-184 in tiered partnership situations. The IRS has requested comments on this issue, as well as the circumstances in which it may be appropriate to permit partners to be employees of the partnership and the impact on employee benefit plans and on employment taxes if Rev. Rul. 69-184 were to be modified to permit partners in certain circumstances also to be employees.

2. Advice for those wishing to minimize self-employment tax liability through the S corporation “Edwards/Gingrich loophole”—failure to have the S corporation contract with those making the payments can be fatal. Fleischer v. Commissioner, T.C. Memo. 2016-238 (12/29/16). The taxpayer, a financial consultant who developed investment portfolios, formed an S corporation of which he was the sole shareholder and the president, secretary, and treasurer. He entered into an employment agreement with the S corporation, pursuant to which he was paid an annual salary. In each of the years in question, the taxpayer included just under $35,000 in gross income as compensation for services and reported nonpassive income on Schedule E ranging from $11,924 to $147,642. The taxpayer did not report any self-employment tax due. The gross receipts of the S corporation were largely attributable to a representative agreement into which the taxpayer entered with Linsco/Private Ledger Financial Services (LPL) and a broker contract into which he entered with MassMutual Financial Group. The taxpayer entered into both contracts himself, i.e., the S corporation was not a party to either contract. In fact, the taxpayer entered into the contract with LPL before the S corporation came into existence. The IRS issued a notice of deficiency in which the IRS asserted that the taxpayer should have reported the gross receipts as self-employment income on Schedule C attached to his individual income tax returns for the years in issue. The Tax Court (Judge Paris) agreed with the government. The court framed the question as “who controls the earning of the income” and stated that two elements must be satisfied for a corporation (rather than its service-provider employee) to be the controller of the income: (1) the individual providing the services must be an employee of the corporation whom the corporation can direct and control in a meaningful sense, and (2) a contract or similar indicium recognizing the corporation’s controlling position must exist between the corporation and the person or entity using the services. In this case, the court reasoned, the second element was not satisfied because there was no contract or other indicium that the S corporation exhibited control over the taxpayer. The court rejected the taxpayer’s argument that it was impossible for LPL and MassMutual to enter into contracts with the S corporation because the corporation was not a registered entity under the securities laws and regulations.

3. Doctor, doctor, give me the news he’s got a [good] case the IRS will lose. The distributive share of income of a physician-member of an LLC operating a surgery center was passive income and not subject to self-employment tax. Hardy v. Commissioner, T.C. Memo. 2017-16 (1/17/17). The taxpayer, a plastic surgeon who performed surgeries in various facilities, paid $163,974 to become a member of a limited liability company (classified for federal tax purposes as a partnership) with a 12.5 percent interest. The seven other members of the LLC also were physicians. The LLC, referred to as MBJ, operated a surgery center equipped for physicians to perform procedures that required either local or general anesthesia. The taxpayer performed approximately 50 percent of his surgeries in his office (located next to MBJ), 20 percent at MBJ, and the remainder at other facilities. MBJ hired its own employees, none of whom were shared with the taxpayer’s practice, and the taxpayer never managed MBJ and had no day-to-day responsibilities there. Patients who elected to have their surgeries performed at MBJ paid three separate fees: (1) for the services of the surgeon performing the surgery, (2) for the services of an anesthesiologist, and (3) a facility fee payable to MBJ. The taxpayer received distributions from MBJ regardless of whether he performed any surgeries there and his distribution was not dependent on the number of surgeries he performed
at MBJ. For years prior to 2008, the taxpayer (whose return was prepared by a CPA) reported his distributive share of MBJ’s income as nonpassive. For the years 2008 through 2010, the taxpayer reported his distributive share of MBJ’s income as passive income and paid self-employment tax. The IRS issued a notice of deficiency disallowing the taxpayer’s passive activity loss deduction for each of these years. The Tax Court (Judge Buch) held that the taxpayer’s distributive share of MBJ’s income was passive income. The court concluded that the taxpayer did not materially participate in MBJ’s activity of operating a surgery center and rejected the IRS’s arguments that the taxpayer either had already or was required to group his ownership interest in MBJ with his medical practice. The court analyzed Reg. § 1.469-4(f) and Technical Advice Memorandum 201634022 (8/19/16), which involved facts similar to those of the taxpayer and his interest in MBJ. The court concluded: “While some facts support treating [the taxpayer’s] ownership interest in MBJ and his medical practice as a single economic unit, the weight of the evidence supports treating them as separate units.”

- The court also held that the taxpayer’s distributive share of MBJ’s income for the years in question was not subject to self-employment tax. (The court permitted the taxpayer to amend the pleadings to conform to the evidence presented at trial in order to make this argument.) Under § 1402(a), a partner’s distributive share of partnership income generally is treated as net earnings from self-employment, but § 1402(a)(13) excludes from this treatment the distributive share of income of a limited partner (other than guaranteed payments for services). The court discussed its decision in Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011), in which the court held that partners in a law firm organized as a limited liability partnership were subject to self-employment tax on their distributive share of partnership income because that income was derived from legal services performed by the partners in their capacity as partners, and therefore “they were not acting as investors in the law firm.” In contrast, the court reasoned, the taxpayer in this case was an investor in MBJ:

  Although [the taxpayer] performs surgeries at MBJ, he is not involved in the operations of MBJ as a business. In contrast to the partners in [Renkemeyer], who are lawyers practicing law and receiving distributive shares based on their fees from practicing law, [the taxpayer] is receiving a distribution based on the fees that patients pay to use the facility. The patients separately pay [the taxpayer] his fees as a surgeon, and they separately pay the surgical center for use of the facility in the same manner as with a hospital.

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

1. Congress enacts a big break for small employers that offer health reimbursement arrangements. The 21st Century Cures Act (“Cures Act”), Pub. L. No. 114-255, was signed by the President on 12/13/16. Among other changes, the Cures Act made several modifications to the rules related to health reimbursement arrangements. These include (1) exempting health reimbursement arrangements that meet the definition of a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA) from the § 4980D excise tax; (2) imposing new reporting requirements related to QSEHRAs; (3) requiring the inclusion in an employee’s gross income of payments or reimbursements under a QSEHRA for employees that do not have minimum essential coverage; (4) limiting or potentially eliminating the § 36B premium tax credit for employees covered by a QSEHRA; and (5) requiring that the employer’s cost for a QSEHRA be taken into account in determining the applicability of the Cadillac Tax. These changes generally are effective for years beginning after 12/31/16.

2. Veterans have extra time to claim refunds for taxes improperly withheld from amounts received for combat-related injuries. The Combat-Injured Veterans Tax Fairness Act of 2016 (2016 CIVTFA), Pub. L. No. 114-292, was signed by the President on 12/16/16. Section 104(a)(4) and (b) exclude from gross income amounts received as a pension, annuity, or similar allowance for a combat-related injury. In St. Clair v. United States, 778 F.
Supp. 894 (E.D. Va. 1991), the court held that a lump sum disability-related severance payment received by a veteran was excluded from the recipient’s gross income under § 104(a)(4). Despite these authorities, since 1991, the Department of Defense has withheld taxes from severance pay for wounded veterans. The 2016 CIVTFA directs the Secretary of Defense to ensure that taxes are not withheld prospectively. In addition, the legislation directs the Secretary of Defense, within one year of the date of enactment, to identify all severance payments from which taxes were improperly withheld, notify each recipient of the improper withholding, and provide each recipient with instructions on filing amended returns to recover these amounts. The legislation extends the limitations period of § 6511(a) on filing claims for refund to the date that is one year after the required notification of improper withholding and eliminates the restriction of § 6511(b)(2) that would normally apply on the amount of tax recoverable.