

# Recent Developments in Federal Income Taxation

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## Employee Retention Credit 2017 Disaster Relief Act (9/29/17)

### *Outline: item F.1, page 2*

- The Disaster Relief and Airport and Airway Extension Act of 2017, § 503, Pub. L. No. 115-63 (9/29/17) provides:
  - “Eligible employer” can include “Hurricane Harvey employee retention credit” among components of general business credit under § 38(b).
- Credit is 40 percent of “qualified wages” for each “eligible employee.”
  - Cap on qualified wages is \$6,000, so maximum credit is \$2,400/employee.
- *Eligible employer*: one that operated an active trade or business in a Harvey/Irma/Maria disaster zone if, because of damage from hurricane, it became inoperable after a specified date and before 1/1/18.
  - Specified dates: 8/23/17 (Harvey), 9/4/17 (Irma), 9/16/17 (Maria).
- *Eligible employee*: principal place of employment (PPE) was in the relevant disaster zone on the relevant specified date.
- *Qualified wages*: wages paid or incurred by eligible employer with respect to eligible employee from date the PPE became inoperable through date the business resumed significant operations at PPE. <sup>2</sup>

**Employee Retention Credit  
2017 Disaster Relief Act (9/29/17)**

***Outline: item F.1, page 2***

- Issues:
  1. Can an employer claim the employee retention credit and the work opportunity credit for the same employee?
    - No, not for the same period. The legislation addresses this.
    - See also IRS Q&A issued in 2007 in response to midwestern storms and guidance issued for 2005 Hurricanes Katrina/Rita.
  2. Must the business be physically damaged to be considered inoperable?
    - No. A business can be inoperable if it is physically inaccessible to employees, raw materials, utilities, or customers.
    - See IRS Q&A issued in 2007 in response to midwestern storms and guidance issued for 2005 Hurricanes Katrina/Rita.
  3. Can an employer deduct wages and take the credit?
    - No. Deduction is reduced by the amount of the credit (40% of wages).
    - See IRS Form 5884-A issued guidance issued for 2008 storms.

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**Use of Retirement Funds by Hurricane Victims  
2017 Disaster Relief Act (9/29/17)**

***Outline: item B.1.a, page 4***

- The Disaster Relief and Airport and Airway Extension Act of 2017, § 502, Pub. L. No. 115-63 (9/29/17), provides special rules for distributions and loans from qualified employer plans (and distributions from IRAs) to victims of Harvey, Irma, and Maria.
- “Qualified hurricane distributions”
  - Up to \$100,000 not subject to normal 10% penalty for early withdrawal.
  - Income is reported ratably over 3 years unless taxpayer elects otherwise.
  - Can be recontributed to an eligible plan or IRA within 3 years (i.e., rollover)
    - See IRS Form 8930 and its instructions for guidance.
  - Are not subject to normal 20% withholding that applies to rollovers.
  - Defined as distributions from an eligible retirement plan before 1/1/19 and on or after 8/23/17 to an individual whose principal place of abode on 8/23 was in the Hurricane Harvey disaster area and who sustained an economic loss by reason of Hurricane Harvey.
    - Similar definitions for Irma (9/4/17) and Maria (9/16/17).

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**Use of Retirement Funds by Hurricane Victims  
2017 Disaster Relief Act (9/29/17)**

***Outline: item B.1.a, page 4***

- Distributions for Home Not Constructed or Purchased. Section 502(b) of the legislation:
  - Permits an individual who received a “qualified distribution” to recontribute it from 8/23/17 to 2/28/18 to a qualified employer plan or IRA
    - “Qualified distribution” is one received after 2/28/17 and before 9/21/17 that was to be used to construct or purchase a principal residence in the Harvey/Irma/Maria disaster area that was not constructed or purchased on account of the hurricanes.
- Loans. Section 502(c) of the legislation:
  - For a “qualified individual”
    - Increases the limit on retirement plan loans to lesser of \$100,000 or 100% of present value for loans made from 9/29/17 through 12/31/18.
    - Extends due date for payments due by 12/31/18 on outstanding loans.
  - “Qualified individual:” principal place of abode on 8/23 was in Hurricane Harvey disaster area and sustained economic loss from the hurricane.

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**Hann v. United States  
120 A.F.T.R.2d 2017-5518 (Fed. Cl. 8/17/17)**

***Outline: item C.1, page 5***

- The taxpayer was the CFO of a corporation and held nonqualified stock options.
- He had the opportunity to sell stock in an IPO of the corporation.
  - The taxpayer engaged in a “cashless” exercise of his stock options, i.e., did not have to pay strike price out of pocket.
  - Paid \$561,000 for stock worth \$1.34 million, and therefore had compensation income of \$776,000, reported on W-2.
  - Taxpayer paid underwriters a commission of \$77,000 to sell in IPO.
- Issue: is the \$77,000 a short-term capital loss (sold stock worth \$1.34 million but received \$77,000 less than that), or a deductible expense that reduces his compensation income of \$776,000?
- Held: A short-term capital loss. The commission reduces the sale proceeds from the stock.

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## **Casualty Losses of Hurricane Victims 2017 Disaster Relief Act (9/29/17)**

### ***Outline: item D.1, page 6***

- The Disaster Relief and Airport and Airway Extension Act of 2017, § 504(b), Pub. L. No. 115-63 (9/29/17), provides special rules for disaster losses in specified areas attributable to Harvey, Irma, or Maria.
- A “net disaster loss”
  - Is deductible only to extent it exceeds \$500 (rather than normal \$100)
  - Is deductible without regard to normal 10% of AGI threshold.
  - Is deductible by those who do not itemize—standard deduction increased
- Example:
  - Individual has AGI of \$90,000, loss from theft of car of \$10,000 (not disaster-related), and \$50,000 net disaster loss from hurricane.
  - Theft loss deductible is \$900 (\$10,000 less \$100 less 10% of AGI)
  - Net disaster loss deductible is \$49,500 (\$50,000 less \$500)
- Net disaster loss: amount by which “qualified disaster-related personal casualty losses” exceed personal casualty gains
  - Generally, a casualty loss attributable to the hurricane that arises in the disaster area on or after 8/23 (Harvey), 9/4 (Irma), or 9/17 (Maria)

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## **Use of Prior-Year Earned Income for EITC and CTC 2017 Disaster Relief Act (9/29/17)**

### ***Outline: item D.2, page 7***

- The Disaster Relief and Airport and Airway Extension Act of 2017, § 504(c), Pub. L. No. 115-63 (9/29/17):
  - Permits a “qualified individual” to elect to use prior-year earned income for purposes of determining eligibility for the earned income tax credit (§ 32) and child tax credit (§ 24) .
- Available to qualified individuals whose earned income for the tax year that includes a specified date is lower than the preceding year.
  - Specified dates are 8/23/17 (Harvey), 9/4/17 (Irma), 9/16/17 (Maria)
- Election applies to both credits (cannot choose)
- Election is available to joint filers if either spouse is a qualified individual
  - In this case, prior-year earned income is combined earned income.
- Qualified individual: individual whose principal place of abode on 8/23/17 was (1) in Hurricane Harvey disaster *zone*, or (2) outside disaster zone, but within Hurricane Harvey disaster *area* if was displaced by the hurricane. (Similar definitions apply for Irma and Maria.)

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**Kardash v. Commissioner,  
866 F.3d 1249 (11th Cir. 8/4/17)**

***Outline: item H.1, page 8***

- The taxpayer was a minority shareholder and president of manufacturing and operations of a profitable corporation
  - He was unaware that the majority shareholders had siphoned off \$120 million and that the corporation had not paid federal taxes.
  - Taxpayer received dividends from the corporation in 2005, 2006, and 2007.
  - The corporation became insolvent and was left with \$3 to \$8 million in assets and back taxes owed of \$129 million.
- Issue: was the taxpayer liable for \$3.4 million of the corporation's taxes as a transferee under § 6901?
- Held: Yes. Court rejected taxpayer's arguments that: (1) the amounts paid to him were really compensation, not dividends, and (2) the IRS had to exhaust its remedies against the corporation first.

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**Avrahami v. Commissioner,  
149 T.C. No. 7 (8/21/17)**

***Outline: item H.2, page 9***

- Two married taxpayers were shareholders of an S corporation that operated jewelry stores. They also held real estate companies.
  - They paid approximately \$156,000 per year for commercial insurance.
- The taxpayers entered into a micro-captive insurance arrangement.
  - They formed an insurance company, owned by the wife, in St. Kitts. The company made the § 831(b) election.
  - The company issued P&C insurance to taxpayers' entities and also reinsured terrorism insurance. Its existing insurance stayed in force.
  - Annual premiums paid to the company were nearly \$1.2 million.
- Held: (1) the arrangement is not insurance and premiums are not deductible; (2) the company was not an insurance company and its § 831(b) election therefore was invalid; (3) \$500,000 of company's surplus made available to the taxpayers was includible in gross income. See also Notice 2016-66 (such transactions are "transactions of interest<sup>9</sup>").

**B.C. Ranch II, L.P. v. Commissioner,  
867 F.3d 547 (5th Cir. 8/11/17)  
*Outline: item C.1.a, page 11***

- A limited partnership developed a tract of several thousand acres of land (known as Bosque Canyon Ranch) into homesites and constructed various amenities.
  - Each limited partner contributed \$350,000, and the partnership subsequently distributed a 5-acre parcel of undeveloped land.
  - The partnership also granted a conservation easement on 1,750 acres of Bosque Canyon Ranch.
- Issue: did the Tax Court correctly conclude that: (1) the contributions and distributions were disguised sales, and (2) the deduction for the easement was disallowed because the easement did not protect the property in perpetuity & baseline documentation was insufficient?
- Held: Vacated and remanded. Not all of the partners' contributions were part of the disguised sale; the property was protected in perpetuity; baseline documentation was sufficient.

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**Freedom Path, Inc. v. Internal Revenue Service,  
120 A.F.T.R. 2d 2017-5125 (N.D. Tex. 7/7/17)  
*Outline: item A.1, page 10***

- Freedom Path, Inc. was denied recognition as a tax-exempt organization under § 501(c)(4).
- Rev. Rul. 2004-6 sets forth an 11-factor facts-and-circumstances test to determine whether certain activity by tax-exempt § 501(c)(3) or (c)(4) organizations is impermissible political campaign activity.
- Held: Rev. Rul. 2004-6 is neither unconstitutionally vague nor overbroad on its face.
  - The court did not address whether the test in Rev. Rul. 2004-6 is unconstitutional as applied.

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**Rutkoske v. Commissioner,  
149 T.C. No. 6 (8/17/17)  
Outline: item B.1, page 13**

- The taxpayers were two brothers who worked at least 2,500 hours annually as farmers.
  - They each owned one-half of an LLC that held 355 acres, which the LLC leased to a partnership through which they conducted their farming operations.
  - In 2009, the LLC granted a conservation easement worth \$1.3 million on the 355 acres and sold its remaining rights in those acres and reported capital gain of \$1.7 million.
- Issue: were the taxpayers subject to the normal limit on charitable contributions of 50% of contribution base (AGI), or were they “qualified farmers” under § 170(b)(1)(E)(iv) and therefore able to deduct 100% of the charitable contribution?
- Held: the taxpayers were not “qualified farmers.” The \$1.7 million capital gain income was not income from farming, and therefore 50% of their gross income was not from farming.

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**Charitable Contributions : Victims of Harvey, Irma, Maria  
2017 Disaster Relief Act (9/29/17)  
Outline: item B.2, page 14**

- The Disaster Relief and Airport and Airway Extension Act of 2017, § 504(a), Pub. L. No. 115-63 (9/29/17):
  - “Qualified contributions” by an individual or corporation are not subject to normal limits on charitable contrib’s (50% of AGI or 10% of taxable income)
  - In effect, the legislation:
    - Permits individuals to deduct qualified contributions up to 100% of taxpayer’s contribution base (AGI) after taking into account other charitable contributions.
    - Permits corporations to deduct qualified contributions up to 100% of taxable income after taking into account other contributions.
    - Excess can be carried forward 5 years
- Qualified Contributions: charitable contribution paid *in cash* to an eligible organization from 8/23/17 to 12/31/17 for relief efforts in the Harvey/Irma/Maria disaster areas if the taxpayer elects to treat as a qualified contribution and obtains a *written acknowledgement* that contribution was or will be used for those relief efforts.

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**Mescalero Apache Tribe v. Commissioner,  
148 T.C. No. 11 (4/5/17)  
Outline: item B.1, page 14**

- The IRS asserted that the Tribe was liable for the taxes that it should have withheld with respect to workers who, according to the IRS, were employees, but whom the Tribe had classified as independent contractors.
- An employer is not liable for withholding taxes if the taxes are actually paid. See § 3402(d).
  - The Tribe tried to determine if the workers had paid the taxes.
  - The Tribe was unable to locate 70 of the workers and therefore could not have them complete IRS Form 4669.
- Issue: could the Tribe obtain discovery in the Tax Court of the IRS's records of these workers to determine if the taxes had been paid?
- Held: Yes. These records are not protected return information under the exception in § 6103(h)(4)(C). But see CCA 201723020 (5/5/17).

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**Notice 2017-38, 2017-30 I.R.B. 147 (7/7/17)  
Second Report to the President (10/2/17)  
Outline: item H.1, page 16**

- Executive Order 13789 (4/21/17) directs Treasury to review “all significant tax regulations” issued on or after January 1, 2016, that “impose an undue financial burden,” “add undue complexity,” or “exceed [the IRS’s] statutory authority,” and to submit two reports.
- In response, Treasury issued:
  - Notice 2017-38 (the first report), which identified eight sets of regulations that possibly met these criteria, and
  - A report on 10/2/17 (the second report) that recommends certain actions regarding these sets of regulations.
- Some regulations are to be withdrawn entirely, others partially, and others to be substantially revised.

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