Recent Developments in Federal Income Taxation

Bruce A. McGovern
Professor of Law and Director, Tax Clinic
South Texas College of Law Houston
Houston, Texas

State Bar of Texas Tax Section
First Wednesday Tax Update
August 1, 2018

To obtain today's outline and slides:
https://tinyurl.com/outline-aug18

https://tinyurl.com/slides-aug18

RJ Channels, Inc. v. Commissioner, T.C. Memo. 2018-27 (3/4/18)
Outline: item D.1, page 3

- The taxpayer, a tax services firm, was a subchapter C corporation that used the accrual method of accounting.
- The taxpayer:
  - Received payments from clients and represented that it would return the funds if it were unable to obtain a favorable result for the client.
  - Paid legal fees and taxes on behalf of clients and was later reimbursed.
- Issues:
  1. Must the taxpayer include the payment from clients in gross income in the year of receipt?
  2. Can the taxpayer deduct amounts paid on behalf of clients?
- Held:
  1. Yes. Taxpayer's obligation to repay was a condition subsequent. Under *Schlude v. Comm.* (U.S. 1963), taxpayer had income in the year of receipt.
  2. Amounts paid for the obligations of another taxpayer are not ordinary and necessary expenses within the meaning of § 162(a).

Franco v. Comm., T.C. Summ. Op. 2018-9 (03/06/18)
Pourmirzaie v. Comm., T.C. Memo. 2018-26 (3/8/18)
Outline: item I.1, page 4

- The taxpayers in both cases had rental real estate activities that generated losses.
- In *Franco*, the taxpayer:
  - Testified that, because his tenants "were not attentive to trash disposal matters" he made weekly trips to ensure that "trash bins were set out for collection."
  - Produced an activity log, numerous emails, and home improvement store receipts relating to his rental properties.
- In *Pourmirzaie*, the taxpayers testified and produced a calendar that was reconstructed from memory during the course of the audit.
- Issue: although rental activities are generally automatically passive activities (§ 469(c)(2)), were the taxpayers real estate professionals under § 469(c)(7), therefore allowing them to establish material participation and avoid having passive losses?
- Held: Yes in *Franco*; no in Pourmirzaie. The taxpayers' records and testimony in *Pourmirzaie* were contradicted by bank statements showing out-of-town dinners on days they claimed to be at the rental properties.

Keefe v. Commissioner, T.C. Memo. 2018-28 (3/15/18)

Outline: item A.1, page 4

- The taxpayers, a married couple, acquired and restored Wrentham House, a historic mansion in Newport, Rhode Island.
  - From 2000 to 2008 they spent $10 million repairing and restoring the mansion with the goal of turning it into a luxury vacation rental property.
  - The taxpayers contacted a real estate agent, who orally informed clients of the property
  - When the work was completed in 2008, the taxpayers never rented the property.
  - They sold it in a short sale for $6 million and realized a large loss.
- Issue: is the taxpayer's loss a capital loss, or instead a § 1231 loss that was converted by § 1231 to an ordinary loss?
- Held: a capital loss. The property was not "used in a trade or business" within the meaning of § 1231, and therefore was a capital asset.
- https://tinyurl.com/wrentham

5

Notice 2018-61 2018-31 I.R.B. 278 (07/13/18)

Outline: item C.1.a, page 5

- TCJA: under new § 67(g), "miscellaneous itemized deductions" are not deductible for 2018 though 2025.
- The notice provides:
  - Treasury and IRS intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct investment- and tax-related expenses just as they could prior to the enactment of new § 67(g).
- This means that estates and trusts still can deduct costs that would not have been incurred if the property were not held in such estate or trust.
- Example: the fee for preparing an estate tax return is deductible.

6

Notice 2018-38
2018-18 I.R.B. 522 (04/16/18).
Outline: item A.1.c, page 7

- Provides guidance to non-calendar taxable year C corporations with regard to the 2017 Tax Cuts and Jobs Act's reduction in the corporate rate and repeal of the AMT effective as of December 31, 2017.
- In the case of a C corporation with a fiscal taxable year that includes (but does not start with) January 1, 2018, § 15 mandates that a blended rate apply for purposes of calculating regular income tax and the AMT.

7

Mellow Partners v. Commissioner,
890 F.3d 1070 (D.C. Cir. 5/22/18)
Outline: item F.1.a, page 9

- The TEFRA audit rules do not apply to "any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner."
  - This exception does not apply to a "pass-thru partner" as defined in § 6231(a)(9). Held: a disregarded LLC is a "pass-thru partner" as defined in § 6231(a)(9).
- Held: a disregarded LLC is a pass-thru partner, and therefore a partnership with a disregarded LLC as a partner was subject to the TEFRA audit rules.
- Accord: *Seaview Trading, LLC v. Commissioner*, 858 F.3d 1281 (9th Cir. 6/7/17).

8

Notice 2018-55
2018-26 I.R.B. 773 (06/08/18)
Outline: item A.1.b, page 10

- 2017 TCJA enacted new § 4968, which imposes a 1.4% excise tax on the "net investment income" of certain private colleges and universities.
- IRS has announced:
  - Proposed regulations under § 4968 will determine "net investment income" gains and losses of an "applicable educational institution" by reference to an endowment asset's fair market value as of December 31, 2017, not its historical adjusted basis (unless historical adjusted basis is greater than fair market value as of December 31, 2017).
- This rule allows an applicable educational institution to use the greater of (i) fair market value as of the end of the taxable year of enactment of the statute or (ii) historical adjusted basis for purposes of calculating net investment income.

9

Rev. Proc. 2018-38
2018-31 I.R.B. ____ (07/16/18)
Outline: item A.1.b, page 10

- Tax-exempt organizations <u>other than</u> § 501(c)(3) organizations no longer need to disclose the names of "substantial contributors" on their Forms 990.

10

Other Developments

- Blackburn v. Commissioner, 150 T.C. No. 9 (4/5/18) (item A.1.c, page 14)
- Kasper v. Commissioner, 150 T.C. No. 2 (1/9/18) (item H.1, page 15)
- Wisconsin Central Ltd. v. United States, ___ U.S. ___, 138 S. Ct. 2067 (6/21/18) (item A.1.a page 16)

11