RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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State Bar of Texas Tax Section
First Wednesday Tax Update
August 7, 2019

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I. ACCOUNTING

A. Accounting Methods

1. Many small businesses will not qualify for several simplifying provisions enacted in the 2017 Tax Cuts and Jobs Act, such as use of the cash method of accounting, because they meet the definition of a "tax shelter." In a letter to the IRS dated February 13, 2019, the American Institute of Certified Public Accountants has brought to the attention of the IRS the concern of many small businesses that, absent relief, they are ineligible for certain simplifying provisions enacted as part of the 2017 Tax Cuts and Jobs Act (TCJA) because the businesses meet the definition of a "tax shelter." 2019 TNT 31-16 (2/13/19). The letter requests appropriate relief.

Certain simplifying provisions enacted by the TCJA are available to businesses with average annual gross receipts not exceeding $25 million. The TJCA enacted several simplifying provisions that are available to a business if the business's average annual gross receipts, measured over the three prior years, do not exceed $25 million. These include the following: **(1)** the ability of C corporations or partnerships with a C corporation as a partner to use the cash method of accounting (§ 448(b)(3)), **(2)** the ability to use a method of accounting for inventories that either treats inventories as nonincidental materials and supplies or conforms to the taxpayer's financial accounting treatment of inventories (§ 471(c)(1)), **(3)** the ability to be excluded from applying the uniform capitalization rules of § 263A (§ 263A(i)), **(4)** the small construction contract exception that permits certain taxpayers not to use the percentage-of-completion method of accounting for certain construction contracts (§ 460(e)(1)(B)), and **(5)** the ability to be excluded from the § 163(j) limit on deducting business interest (§ 163(j)(3)).

The simplifying provisions enacted by the TCJA generally are not available to a "tax shelter." The simplifying provisions for small businesses listed above each state that they are not available to "a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)." Section 448(a)(3) provides that a "tax shelter" cannot compute taxable income under the cash receipts and disbursements method of accounting, and according to § 448(d)(3), the term "tax shelter" for this purpose is defined in § 461(i)(3). Section 461(i)(3) defines the term "tax shelter" as "(A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale, (B) any syndicate (within the meaning of section 1256(e)(3)(B)), and (C) any tax shelter (as defined in section 6662(d)(2)(C)(ii))."

Many small businesses will meet the definition of a "syndicate" and therefore will be considered tax shelters. As discussed, the term "tax shelter" includes "any syndicate (within the meaning of section 1256(e)(3)(B))." The term "syndicate," according to § 1256(e)(3)(B), is "any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs." Many small businesses will meet this definition and will be precluded from using the simplifying provisions enacted by the TCJA. Businesses that fluctuate between having income and having losses could be in the position of having to change accounting methods.

The AICPA has requested relief. The AICPA has asked the IRS to exercise its authority, granted by § 1256(e)(3)(B), to treat an interest in an entity as not being held by a limited partner or a limited entrepreneur if certain conditions are met.

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

E. Depreciation & Amortization

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

1. The Eleventh Circuit has reversed a federal district court and held that the government failed to establish that an individual who reimbursed her ex-husband for federal taxes could not determine her tax liability under § 1341 for the year she paid the reimbursement. Mihelick v. United States, 123 A.F.T.R.2d 2019-2251 (11th Cir. 6/18/19). The taxpayer, Nora Mihelick, and her former husband, Michael Bluso, divorced in 2005. During their marriage, they had both worked at Gotham Staple Company, a closely held Ohio corporation owned by her ex-husband's family and for which her ex-husband served as chief executive officer. While their divorce was pending, her ex-husband's sister, a minority shareholder in Gotham Staple Company, sued the taxpayer's ex-husband and asserted claims of breach of fiduciary duty on the basis that he had excessively compensated himself at Gotham's expense. Although the taxpayer initially resisted it, she and her ex-husband negotiated a provision in their separation agreement under which any liability arising from the litigation over her ex-husband's alleged breach of fiduciary duty would be a marital liability for which they would be jointly and severally liable because, if such a liability came into existence, it would arise from the acquisition of marital assets during their marriage. In 2007, the taxpayer's ex-husband settled the litigation pending against him and paid $600,000. The taxpayer resisted reimbursing her ex-husband but, after being advised by her attorney that she had an obligation to do so, she paid him $300,000 in 2009. Her ex-husband determined his liability for federal income tax for the year in which he made the $300,000 settlement payment by applying § 1341, which, if certain requirements are met, allows a taxpayer who must repay an amount previously included in income either to deduct the amount repaid or take a tax credit for the amount of tax overpaid in the year the income was included. On the taxpayer's federal income tax return for 2009, the year in which she reimbursed her former husband, she determined her tax liability by applying § 1341 and claimed a refund, which the IRS denied. Following the denial of her refund claim, the taxpayer brought this legal action seeking a refund in U.S. District Court. The District Court concluded that the taxpayer did not satisfy all requirements to determine her tax liability under § 1341, granted summary judgment for the government, and the taxpayer appealed. In an opinion by Judge Rosenbaum, the Eleventh Circuit held that the evidence supported the conclusion that the taxpayer satisfied all of the elements of § 1341 and that it was inappropriate for the District Court to grant summary judgment in favor of the government. The Eleventh Circuit remanded to the District Court to determine whether there was any genuine issue of material fact concerning any of the elements of § 1341 and, if not, to enter judgment in favor of the taxpayer. If the District Court concludes that there is a genuine issue of material fact, then the case must proceed to trial. In either case, if the taxpayer prevails, she will be entitled to determine her tax liability for 2009 by choosing whichever of the following will provide her with the better result: (1) deducting the $300,000 she paid to her former husband in 2009, or (2) hypothetically recalculating her tax liability for the prior year in which she included the $300,000 in gross income by omitting the $300,000 from gross income, determining the amount by which her tax liability would have been reduced in that year, and taking the amount of the reduction as a credit in 2009. To obtain the benefit of § 1341, four requirements must be satisfied. The court analyzed these requirements as follows:

1. The first requirement is that the taxpayer must have *included an item in gross income for a prior year* "because it *appeared that the taxpayer had an unrestricted right to such item*." The government argued that this requirement was not met because the taxpayer's former husband had no unrestricted right to the income in the year the couple included it in gross income because he had misappropriated the funds, and therefore she could not have had an unrestricted right to the income. The court rejected this argument because there was no proof her former husband had misappropriated the funds and the settlement agreement that resolved the litigation against him expressly disclaimed any wrongdoing. The court similarly rejected the argument that the taxpayer had no unrestricted right to her former husband's income under the provisions of Ohio law concerning marital property: "What matters is whether [the taxpayer] sincerely believed she had a right to Bluso's income, not the correctness of her belief." The court concluded that there was enough evidence in the record to support the taxpayer's sincere belief that she had an unrestricted right to his income in the years they were married.

2. The second requirement for a taxpayer to use § 1341 is that the *taxpayer must have later learned that she actually "did not have an unrestricted right" to that income*. According to the court, "[t]o make this showing, the taxpayer must demonstrate that she involuntarily gave away the relevant income because of some obligation, and the obligation had a substantive nexus to the original receipt of the income." The court concluded that both aspects of this requirement were satisfied. In doing so, the court rejected the government's argument that the fact that the taxpayer had reimbursed her former husband and had not paid her portion of the liability directly to the opposing party in the lawsuit precluded her from satisfying this requirement.

3. The third requirement of § 1341 is that *the amount the taxpayer did not have an unrestricted right to* and repays *must have exceeded $3,000.* The parties agreed that this requirement was satisfied.

4. The final requirement of § 1341 is that *the amount the taxpayer did not have an unrestricted right to* and repays *must be deductible under another provision of the Internal Revenue Code*. The court held that this requirement was met because her former husband was entitled to deduct the payment as a loss under § 165(c)(1) (losses incurred in a trade or business) and, by extension, the taxpayer was as well.

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. IRS Chief Counsel says that an individual who is a 2-percent S corporation shareholder pursuant to the § 318 constructive ownership rules is entitled to a deduction under § 162(*l*) for amounts paid by the S corporation under a group health plan for all employees and included in the individual's gross income if the individual otherwise meets the requirements of § 162(*l*). CCA 201912001, 2019 WL 1573655 (12/21/18, released 3/22/19). In this Chief Counsel Advice, the IRS Office of Chief Counsel concluded that an individual who was treated as a 2-percent S corporation shareholder because the stock of a family member was attributed to the individual under the constructive ownership rules of § 318 could deduct the amounts paid by the S corporation under a group health plan and included in the individual's gross income.

Background. Under § 1372(a), an S corporation is treated as a partnership and a 2-percent shareholder of an S corporation is treated as a partner for purposes of applying the provisions of the Code relating to employee fringe benefits. For this purpose, a 2-percent shareholder is any person who owns (or is considered to own under the constructive ownership rules of § 318) on any day during the S corporation's tax year more than 2 percent of the corporation's outstanding stock or stock possessing more than 2 percent of the total combined voting power of all stock of the corporation. According to Rev. Rul. 91-26, 1991-1 C.B. 184, accident and health insurance premiums paid by an S corporation on behalf of a 2-percent shareholder-employee as compensation for services are treated like guaranteed payments to partners under § 707(c). Therefore, the S corporation can deduct the premiums and the 2-percent shareholder-employee must include an appropriate portion of the premiums in gross income. The S corporation must report the premiums on the 2-percent shareholder-employee's Form W-2, but according to IRS Announcement 92-16, such amounts are not wages subject to Social Security and Medicare taxes if the requirements of the exclusion in § 3121(a)(2)(B) are met. Section 162(*l*) authorizes an above-the-line deduction for a taxpayer who is an employee within the meaning of §401(c)(1) for an amount equal to the amount paid during the year for insurance that constitutes medical care for the taxpayer and the taxpayer's spouse, dependents, and children who have not attained the age of 27. This deduction is available to a 2-percent shareholder-employee of an S corporation if the plan is established by the S corporation. Guidance on when the plan is considered established by the S corporation is provided in Notice 2008-1, 2008-2 I.R.B. 251. The deduction is limited to the taxpayer's earned income from the trade or business with respect to which the plan providing medical care is established and is not available if the taxpayer is eligible to participate in a subsidized health plan maintained by an employer of the taxpayer or of the taxpayer's spouse or dependents.

Facts. An individual owned 100% of an S corporation, which employed the individual's family member. Because of the family relationship, the family member was considered to be a 2-percent shareholder pursuant to the attribution of ownership rules under § 318. The S corporation provided a group health plan for all employees, and the amounts paid by the S corporation under the group health plan were included in the family member's gross income. Chief Counsel was asked whether an individual who was a 2-percent shareholder of an S corporation pursuant to the constructive ownership rules of §318 by virtue of being a family member of the S corporation's sole shareholder was entitled to the deduction under §162(*l*) for amounts that were paid by the S corporation under a group health plan for all employees and included in the individual's gross income.

Chief Counsel's Conclusion. Chief Counsel concluded that "an individual who is a 2-percent shareholder of an S corporation pursuant to the attribution of ownership rules under §318 is entitled to the deduction under § 162(*l*) for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income if the individual otherwise meets the requirements of section 162(*l*)."

B. Qualified Deferred Compensation Plans

1. They were just kidding! Treasury and the IRS no longer plan to amend the regulations under § 401(a)(9) to prohibit giving retirees receiving annuity payments the option to receive a lump sum payment. Notice 2019-18, 2019-13 I.R.B. 915 (3/6/19). A number of sponsors of defined benefit plans have amended their plans to provide a limited period during which certain retirees who are currently receiving lifetime annuity payments from those plans may elect to convert their annuities into lump sums that are payable immediately. These arrangements are sometimes referred to as retiree lump-sum windows. In Notice 2015-49, 2015-30 I.R.B. 79 (7/9/15), the IRS announced that Treasury and the IRS planned to amend the required minimum distribution regulations under § 401(a)(9) to provide that qualified defined benefit plans generally are not permitted to replace any joint and survivor, single life, or other annuity currently being paid with a lump sum payment or other accelerated form of distribution. With certain exceptions, the amendments to the regulations were to apply as of July 9, 2015. Notice 2019-18 provides that Treasury and the IRS no longer intend to propose the amendments to the regulations under § 401(a)(9) that were described in Notice 2015-49. The notice indicates that Treasury and the IRS will continue to study the issue of retiree lump-sum windows. The notice further provides:

> Until further guidance is issued, the IRS will not assert that a plan amendment providing for a retiree lump-sum window program causes the plan to violate § 401(a)(9), but will continue to evaluate whether the plan, as amended, satisfies the requirements of §§ 401(a)(4), 411, 415, 417, 436, and other sections of the Code. During this period, the IRS will not issue private letter rulings with regard to retiree lump-sum windows. However, if a taxpayer is eligible to apply for and receive a determination letter, the IRS will no longer include a caveat expressing no opinion regarding the tax consequences of such a window in the letter.

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

1. "I think, therefore I am." The taxpayer argued that body and mind are inseparable, but the Tax Court gave effect to Internal Revenue Code's dualist view of body and mind and held that the damages received by the taxpayer were for emotional distress and therefore included in gross income. Doyle v. Commissioner, T.C. Memo. 2019-8 (2/6/19). The taxpayer was employed by a corporation in the technology sector but was fired after he brought to the Chief Executive Officer his concerns about the company's anticompetitive behavior. Following his termination, the taxpayer

> couldn't sleep, couldn't digest food properly, and had lots of other health problems. He struggled with chronic headaches, he couldn't concentrate, and he had neck, shoulder, and back pain. His relationship with his wife suffered, and he believes that he'll deal with some of these issues for the rest of his life.

The Tax Court (Judge Holmes) found that the taxpayer's ailments were the consequence of emotional distress he suffered when he was fired. The taxpayer and his former employer entered into a settlement agreement that provided for payment of $350,000 of "alleged unpaid wages," which his employer reported on Form W-2, and also provided for payment of $250,000 "for his alleged emotional distress damages," which his employer reported on Form 1099-MISC. His former employer paid the $250,000 in two equal installments in 2010 and 2011. The taxpayer's CPA, who had more than forty years' experience preparing tax returns, concluded that the $250,000 reported on Forms 1099-MISC were excluded from the taxpayer's gross income under § 104(a)(2), which excludes from gross income the amount of any damages received on account of personal physical injury or physical sickness. The taxpayer's returns for 2010 and 2011 each included a Schedule C on which the taxpayer reported income of $125,000, deducted some legal fees, and also deducted an amount for "personal injury" (2010) or "pain and suffering" (2011) in an amount sufficient to zero out the income on Schedule C. The taxpayer also deducted some legal fees for 2010 on Schedule A. The Tax Court held that the $250,000 received by the taxpayer was includible in the taxpayer's gross income pursuant to the language of § 104(a), which provides that "emotional distress shall not be treated as a physical injury or physical sickness." In reaching this conclusion, the court relied on both its prior decisions (such as *Pettit v. Commissioner*, T.C. Memo. 2008-87) and the legislative history of the 1996 amendments to § 104(a), both of which establish that, for purposes of § 104(a), "emotional distress" includes physical symptoms that result from emotional distress, such as insomnia, headaches, and stomach disorders. The court rejected the taxpayer's argument that his job termination caused stress, and that "one can't really distinguish symptoms of emotional distress from symptoms of other physical injuries or sicknesses because '[p]hysical relates to both the body and mind which are inseparable in a person.'" The court concluded that the taxpayer "may well be right ontologically, but not legally." The court also disallowed the deduction of legal fees on Schedule C (but not on Schedule A because the Service had not challenged those) and declined to impose accuracy related penalties under § 6662(a) because the taxpayer had relied in good faith on the advice of his CPA and also because the Service had not introduced any evidence that the penalties had been "personally approved (in writing) by the immediate supervisor of the individual making [the initial] determination" of the penalty as required by § 6751(b)(1).

- *Tax treatment of the amounts received for unpaid wages.* There apparently was no dispute between the parties that the taxpayer had to include in gross income the $350,000 of "alleged unpaid wages" that his former employer paid and reported on Form W-2 because the court does not separately discuss it. If the taxpayer had suffered a physical injury, however, and if his inability to earn the wages was the result of his physical injury, then he should have been able to exclude the unpaid wages from his gross income under § 104(a)(2) because the exclusion applies to all damages that flow from a physical injury.

- *Taxpayers have prevailed in some cases that are difficult to distinguish.* The Tax Court concluded in this case that, if a defendant's conduct causes a taxpayer to have emotional distress, then the taxpayer cannot exclude from gross income under § 104(a)(2) any damages or settlement payments received because emotional distress is not a physical injury. The court further concluded that this rule applies even if a taxpayer suffers physical symptoms of the emotional distress, such as insomnia or stomach disorders. In some cases, however, the line between a physical injury, on the one hand, and physical symptoms of emotional distress, on the other, has not been entirely clear. For example, in *Parkinson v. Commissioner*, T.C. Memo. 2010-142, the Tax Court concluded that a taxpayer who suffered a heart attack as a result of emotional distress he experienced in the workplace had suffered a physical injury. Similarly, in *Domeny v. Commissioner*, T.C. Memo. 2010-9, the Tax Court held that a taxpayer whose workplace stress resulted in a flare-up of her pre-existing multiple sclerosis condition could exclude from her gross income under § 104(a)(2) a settlement payment received from her former employer. The ambiguity in the law concerning this issue suggests that careful attention and research are required if a client receives damages or settlement payments in a context in which the client might have suffered from emotional distress.

- *Even if a taxpayer suffers only emotional distress, the taxpayer can exclude from gross income an amount of damages received to the extent of medical expenses incurred that were not deducted in prior years.* Although the statutory language of § 104(a) is clear that emotional distress is not considered a physical injury, the statutory language also states that this rule does "not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress." For example, in the case discussed above, if the taxpayer had incurred $10,000 in costs for psychological counseling as a result of his emotional distress, then he could have excluded from gross income $10,000 of the $250,000 in settlement payments received from his former employer provided that he had not deducted any portion of the medical expenses in a prior year. If the taxpayer had deducted in a prior year $4,000 of the $10,000 in medical expenses incurred, then he could have excluded $6,000 of the $250,000 in settlement payments received from his former employer.

2. A stockbroker could not assign income to his defunct corporation, says the Tax Court. Frey v. Commissioner, T.C. Memo. 2019-62 (6/3/19). The taxpayer, who began working as a stockbroker in 1962, was the chief operating officer of three firms, including Queen City Securities and Jettrade, Inc. During the years in question, 2012 and 2013, the taxpayer was the sole shareholder of Queen City Securities and served as president and chief executive officer of Jettrade, in which he held a majority equity interest. Following a series of financial crises, Queen City ceased to conduct business in 1990. The taxpayer claimed that Queen City had net operating losses or bad debt losses carried forward from years prior to 1991. During 2012 and 2013, the taxpayer received compensation from Jettrade of $214,150 and $205,300, respectively, and assigned all of the income to Queen City. He prepared his own federal income tax returns for 2012 and 2013 (in part because he had been dissatisfied with and fired professionals with whom he had worked in the past), which included a Schedule C, Profit or Loss from Business, on which he reported that he worked as a stockbroker as a sole proprietor. On Schedule C, the taxpayer included as income the compensation he received from Jettrade and deducted equal amounts as "commissions and fees" for amounts he allegedly paid to Queen City with the intent to utilize Queen City's loss carryforwards to offset the income. The IRS disallowed the deductions on Schedule C for the amounts paid to Queen City and, as a result, made computational adjustments to increase the taxable portion of the Social Security benefits received by the taxpayer and his wife. The Tax Court (Judge Cohen) agreed with the IRS and held that the taxpayer could not assign his income to Queen City. According to the court, it is well established by cases such as *Lucas v. Earl*, 281 U.S. 111 (1930), that income is taxable to the person who earns it. The proper taxpayer is the person or entity that controls the earning of the income, not the person or entity that ultimately receives it. The court rejected the taxpayer's rather confused arguments to the contrary, concluded that he had presented no evidence that he had actually transferred funds to Queen City, and also concluded that his testimony at trial was implausible and unreliable and not entitled to any weight. The court upheld the IRS's imposition of accuracy-related penalties under § 6662(a), (b)(1) and (b)(2) for both substantial understatement of income tax and negligence. The IRS established that there was a substantial understatement of income because the understatement exceeded the greater of 10% of the tax required to be shown on the return or $5,000. The court also held that the evidence established that the taxpayer and his wife were negligent because "they did not consult competent professionals or otherwise attempt to determine their correct tax liabilities." They did not establish a reasonable cause defense.

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

D. Deductions and Credits for Personal Expenses

1. Although the IRS treats Medicaid waiver payments as excludable from gross income, such payments are earned income for purposes of the earned income credit and the child tax credit, says the Tax Court. Feigh v. Commissioner, 152 T.C. No. 15 (5/15/19). Medicaid waiver payments are payments to individual care providers for the care of eligible individuals under a state Medicaid Home and Community-Based Services waiver program described in section 1915(c) of the Social Security Act. Generally, these payments are made by a state that has obtained a Medicaid waiver that allows the state to include in the state's Medicaid program the cost of home or community-based services (other than room and board) provided to individuals who otherwise would require care in a hospital, nursing facility, or intermediate care facility. In Notice 2014-7, 2014-4 I.R.B. 445, the Service concluded that Medicaid waiver payments qualify as "difficulty of care payments" within the meaning of § 131(c) and therefore can be excluded from the recipient's gross income under § 131(a), which excludes amounts received by a foster care provider as qualified foster care payments. Generally, difficulty of care payments are compensation for providing additional care to a qualified foster individual that is required by reason of the individual's physical, mental, or emotional handicap and that is provided in the home of the foster care provider. In this case, the taxpayers, a married couple, received Medicaid waiver payments in 2015 in the amount of $7,353, which were reflected on Form W-2, for the care of their disabled adult children. The taxpayers reported this amount as wages on their 2015 return but excluded the payments from gross income. They received no other income during 2015 that would qualify as earned income. The taxpayers claimed an earned income credit of $3,319 and an additional child tax credit of $653. The IRS asserted that the Medicaid waiver payment was not earned income and therefore disallowed the taxpayers' earned income credit and child tax credit. The Tax Court (Judge Goeke) held that the Medicaid waiver payments in the amount of $7,353 did qualify as earned income for purposes of both the earned income credit and the additional child tax credit. For this purpose, section 32(c)(2)(A)(i) defines "earned income" as

> wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the taxable year.

The court reasoned that, even though the taxpayers did not *include* in gross income the Medicaid waiver payments they received, the payments were *includible* in gross income. The court engaged in a lengthy analysis of Notice 2014-7, in which the Service had concluded that such payments could be excluded from gross income under § 131(a) and determined that the notice was entitled to so-called *Skidmore* deference (*Skidmore v. Swift & Co.*, 323 U.S. 134 (1944)), under which a government agency's interpretation is accorded respect befitting "the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those facts which give it the power to persuade, if lacking power to control." The Tax Court concluded that Notice 2014-7 was "entitled to little, if any, deference." In other words, the court concluded that the Service got it wrong when it determined that the taxpayers' Medicaid waiver payments were excludable from gross income. Based on its analysis, the court accepted the taxpayers' argument that the Service could not reach a result contrary to the Code by reclassifying the taxpayers' earned income as unearned for purposes of determining eligibility for the tax credits in question. The Service argued that no statutory provision demonstrated that Congress intended to allow a double benefit, i.e., both an exclusion of the Medicaid waiver payment from gross income and eligibility for the earned income credit and child tax credit. The court responded: "Respondent's argument, however, misses that he, not Congress, has provided petitioners with a double tax benefit."

- The taxpayers were represented by the Low Income Taxpayer Clinic at the University of Minnesota Law School.

2. Has the federal deduction for your high property or state income taxes made them easier to bear? Brace yourself! The deduction for state and local taxes not paid or accrued in carrying on a trade or business or an income-producing activity is limited to $10,000. The 2017 Tax Cuts and Jobs Act, § 11042, amended Code § 164(b) by adding § 164(b)(6). For individual taxpayers, this provision generally (1) eliminates the deduction for foreign real property taxes, and (2) limits to $10,000 ($5,000 for married individuals filing separately) a taxpayer's itemized deductions on Schedule A for the aggregate of state or local property taxes, income taxes, and sales taxes deducted in lieu of income taxes. This provision applies to taxable years beginning after 2017 and before 2026. The provision does *not* affect the deduction of state or local property taxes or sales taxes that are paid or accrued in carrying on a trade or business or an income-producing activity (i.e., an activity described in § 212) that are properly deductible on Schedules C, E, or F. For example, property taxes imposed on residential rental property will continue to be deductible. With respect to income taxes, an individual can deduct only *foreign* income taxes paid or accrued in carrying on a trade or business or an income-producing activity. As under current law, an individual cannot deduct state or local income taxes as a business expense even if the individual is engaged in a trade or business as a sole proprietor. *See* Reg. § 1.62-1T(d).

a. The Service is not going to give blue states a pass on creative workarounds to the new $10,000 limitation on the personal deduction for state and local taxes. Notice 2018-54, 2018-24 I.R.B. 750 (05/23/18). In response to new § 164(b)(6), many states—including Connecticut, New Jersey, and New York—have enacted workarounds to the $10,000 limitation. For instance, New Jersey reportedly has enacted legislation giving property owners a special tax credit against otherwise assessable property taxes if the owner makes a contribution to charitable funds designated by local governments. Connecticut reportedly has enacted a new provision that taxes the income of passthrough entities such as S corporations and partnerships, but allows the shareholders or members a corresponding tax credit against certain state and local taxes assessed against them individually. Notice 2018-54 announces that the Service and Treasury are aware of these workarounds and that proposed regulations will be issued to "make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers." In other words, blue states, don't bank on a charitable contribution or a flow-through income tax substituting for otherwise assessable state and local taxes to avoid new § 164(b)(6). The authors predict that this will be an interesting subject to watch over the coming months.

b. The availability of a business expense deduction under § 162 for payments to charitable organizations is not affected by any state tax credits received for the payments, says the Service. IRS News Release IR-2018-178 (9/5/18). This news release clarifies that the availability of a deduction for ordinary and necessary business expenses under § 162 for businesses that make payments to charities or government agencies and for which the business receives state tax credits is not affected by the proposed regulations issued in August 2018 (that became final in June 2019, see below) that generally disallow a federal charitable contribution deduction under § 170 for charitable contributions made by an individual for which the individual receives a state tax credit. Thus, if a payment to a government agency or charity qualifies as an ordinary and necessary business expense under § 162(a), it is not subject to disallowance in the manner in which deductions under § 170 are subject to disallowance. This is true, according to the news release, regardless of whether the taxpayer is doing business as a sole proprietor, partnership or corporation. According to a "frequently asked question" posted on the Service website, "a business taxpayer making a payment to a charitable or government entity described in § 170(c) is generally permitted to deduct the entire payment as an ordinary and necessary business expense under § 162 if the payment is made with a business purpose."

c. Safe harbors for C corporations and "specified passthrough entities" allow payments made with a business purpose to charities to qualifiy as ordinary and necessary business expenses even if the payors receive state tax credits for the payments. Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (12/29/18). Treasury and the Service obviously have continued to receive questions regarding the deductibility of business expenses that may indirectly bear on the taxpayer's state and local tax liability. In response, Rev. Proc. 2019-12 provides certain safe harbors. For C corporations that make payments to or for the use of § 170(c) charitable organizations and that receive or expect to receive corresponding tax credits against state or local taxes, the C corporation nevertheless may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of § 162(a). A similar safe harbor rule applies for entities other than C corporations, but only if the entity is a "specified passthrough entity." A specified passthrough entity for this purpose is one that meets four requirements. First, the entity must be a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under Reg. § 301.7701-3 (i.e., it is not single-member LLC). Second, the entity must operate a trade or business within the meaning of § 162. Third, the entity must be subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity. Fourth, in return for a payment to a § 170(c) charitable organization, the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax imposed upon the entity. The revenue procedure applies to payments made on or after January 1, 2018.

- *C corporation example state and local income tax credit:* A, a C corporation engaged in a trade or business, makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, A receives or expects to receive a dollar-for-dollar state tax credit to be applied to A's state corporate income tax liability. Under the revenue procedure, A may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under § 162.

- *C corporation example state and local property tax credit:* B, a C corporation engaged in a trade or business, makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, B receives or expects to receive a tax credit equal to 80 percent of the amount of this payment ($800) to be applied to B's local real property tax liability. Under the revenue procedure, B may treat $800 as meeting the requirements of an ordinary and necessary business expense under § 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by the revenue procedure. (In other words, the $200 could be a charitable contribution deductible under § 170, or the $200 could be a business expense deductible under § 162.)

- *Specified passthrough example state and local excise tax credit:* P is a limited liability company (LLC) classified as a partnership for federal income tax purposes under Reg. § 301.7701-3 and is owned by individuals A and B. P is engaged in a trade or business within the meaning of § 162 and makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, P receives or expects to receive a dollar-for-dollar state tax credit to be applied to P's state excise tax liability incurred by P in carrying on its trade or business. Under applicable state law, the state's excise tax is imposed at the entity level (not the owner level). Under the revenue procedure, P may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under § 162.

- *Specified passthrough example state and local property tax credit:* S is an S corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, S receives or expects to receive a state tax credit equal to 80 percent of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying on its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under the revenue procedure, S may treat $800 of the payment as meeting the requirements of an ordinary and necessary business expense under § 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure. (In other words, the $200 could be a charitable contribution deductible under § 170 by the owners of the specified passthrough entity, or the $200 could be a business expense deductible at the entity level under § 162.)

d. And like Rameses II in The Ten Commandments, Treasury says, "So let it be written; so let it (finally!) be done." T.D. 9864, Contributions in Exchange for State or Local Tax Credits, 84 F.R. 27513 (6/13/19). The Treasury Department and the IRS have finalized, with only minor changes, proposed amendments to the regulations under § 170 that purport to close the door on any state-enacted workarounds to the $10,000 limitation of § 164(b)(6) on a taxpayer's itemized deductions on Schedule A for the aggregate of state or local property taxes, income taxes, and sales taxes deducted in lieu of income taxes. (*See* REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18).) Reg. § 1.170A-1(h)(3) generally requires taxpayers to reduce the amount of any federal income tax charitable contribution deduction by the amount of any corresponding state or local tax *credit* the taxpayer receives or expects to receive. The final regulations further provide that a corresponding state or local tax *deduction* normally will not reduce the taxpayer's federal deduction provided the state and local deduction does not exceed the taxpayer's federal deduction. To the extent the state and local charitable deduction exceeds the taxpayer's federal deduction, the taxpayer's federal deduction is reduced. Finally, the final regulations provides an exception whereby the taxpayer's federal charitable contribution deduction is not reduced if the corresponding state or local credit does not exceed 15 percent of the taxpayer's federal deduction. Pursuant to an amendement to Reg. § 1.642(c)-3(g), these same rules apply in determining the charitable contribution deductions of trusts and estates under § 642(c). Three examples illustrate the application of these rules:

- *Example 1*. A, an individual, makes a payment of $1,000 to X, an entity listed in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70% of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by $700 (70% × $1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the $1,000 payment to X may not exceed $300.

- *Example 2*. B, an individual, transfers a painting to Y, an entity listed in section 170(c). At the time of the transfer, the painting has a fair market value of $100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10% of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15% of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

- *Example 3*. C, an individual, makes a payment of $1,000 to Z, an entity listed in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C is not required to reduce its charitable contribution deduction under section 170(a) on account of the state tax deduction.

The final regulations are effective for charitable contributions made after August 27, 2018.

- The final regulations do not discern between abusive "workarounds" enacted in response to § 164(b)(6) and legitimate state and local tax credit programs such as the Georgia Rural Hospital Tax Credit that preceded the 2017 Tax Cuts and Jobs Act. The Georgia Rural Hospital Tax Credit program was enacted in 2017 to combat the closure of many rural hospitals in Georgia due to financial difficulties. Under the program, individuals and corporations making contributions to designated rural hospitals receive a 90 percent dollar-for-dollar tax credit against their Georgia state income tax liability. Is the Georgia Rural Hospital Tax Credit program adversely affected by proposed regulations under § 164(b)(6)? In our view, the answer is "yes" and a Georgia taxpayer's federal charitable contribution deduction for a donation to a Georgia rural hospital is reduced by 90 percent. Treasury and the IRS have adopted this view, which is reflected in the preamble to the final regulations:

> The regulations are based on longstanding federal tax law principles that apply equally to all taxpayers. To ensure fair and consistent treatment, the final regulations do not distinguish between taxpayers who make transfers to state and local tax credit programs enacted after the [Tax Cuts and Jobs] Act and those who make transfers to tax credit programs existing prior to the enactment of the Act. Neither the intent of the section 170(c) organization, nor the date of enactment of a particular state tax credit program, are relevant to the application of the *quid pro quo* principle.

We note, however, that it may be possible under state or local law for a taxpayer to waive any corresponding state or local tax credit and thereby claim a full charitable contribution for federal income tax purposes. *See* Rev. Rul. 67-246, 1967-2 C.B. 104. In the preamble to the final regulations, Treasury and the IRS noted that taxpayers might disclaim a credit by not applying for it if the credit calls for an application (or applying for a lesser amount) and requested comments as to how taxpayers may decline state or local tax credits in other situations. It is also possible, pursuant to a safe harbor established in Notice 2019-12, 2019-27 I.R.B. ___ (see below), for an individual who itemizes deductions to treat as a payment of state or local tax on Schedule A a payment made to a charitable organization for which the individual receives a state or local tax credit.

e. Down the rabbit-hole we go. A safe harbor allows individuals who itemize to treat as payments of state or local tax any payments to § 170(c) charitable organizations that are disallowed as federal charitable contribution deductions because the individual will receive a state or local tax credit for the payment. Notice 2019-12, 2019-27 I.R.B. 57 (6/11/19). This notice announces that the Treasury Department and the IRS intend to publish a proposed regulation that will amend Reg. § 164-3 to provide a safe harbor for individuals who itemize deductions and make a payment to or for the use of an entity described in § 170(c) in return for a state or local tax credit. Until the proposed regulations are issued, taxpayers can rely on the safe harbor as set forth in the notice. Section 3 of the notice provides as follows:

> Under this safe harbor, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in return for a state or local tax credit may treat as a

> payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is or will be disallowed under final regulations. This treatment as a payment of state or local tax under section 164 is allowed in the taxable year in which the payment is made to the extent the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for such taxable year or the preceding taxable year. … To the extent the resulting credit is not applied to offset the individual's state or local tax liability for the taxable year of the payment or the preceding taxable year, any excess credit permitted to be carried forward may be treated as a payment of state or local tax under section 164 in the taxable year or years for which the carryover credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability.

The safe harbor does not apply to a transfer of property and does not permit a taxpayer to treat the amount of any payment as deductible under more than one provision of the Code or regulations. The safe harbor applies to payments made after August 27, 2018. Three examples illustrate the application of these rules:

- *Example 1*. In year 1, Taxpayer A makes a payment of $500 to an entity described in section 170(c). In return for the payment, A receives a dollar-for-dollar state income tax credit. Prior to application of the credit, A's state income tax liability for year 1 was $500 or more; A applies the $500 credit to A's year 1 state income tax liability. Under section 3 of this notice, A treats the $500 payment as a payment of state income tax in year 1 for purposes of section 164. To determine A's deduction amount, A must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

- *Example 2*. In year 1, Taxpayer B makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, B receives a dollar-for-dollar state income tax credit, which under state law may be carried forward for three taxable years. Prior to application of the credit, B's state income tax liability for year 1 was $5,000; B applies $5,000 of the $7,000 credit to B's year 1 state income tax liability. Under section 3 of this notice, B treats $5,000 of the $7,000 payment as a payment of state income tax in year 1 for purposes of section 164. Prior to application of the remaining credit, B's state income tax liability for year 2 exceeds $2,000; B applies the excess credit of $2,000 to B's year 2 state income tax liability. For year 2, B treats the $2,000 as a payment of state income tax for purposes of section 164. To determine B's deduction amounts in years 1 and 2, B must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

- *Example 3*. In year 1, Taxpayer C makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, C receives a local real property tax credit equal to 25 percent of the amount of this payment ($1,750). Prior to application of the credit, C's local real property tax liability in year 1 was $3,500; C applies the $1,750 credit to C's year 1 local real property tax liability. Under section 3 of this notice, for year 1, C treats $1,750 as a payment of local real property tax for purposes of section 164. To determine C's deduction amount, C must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

3. The Tax Court reiterates that it does not have equitable power to change the statutory treatment of excess advance premium tax credits as an increase in tax. Kerns v. Commissioner, T.C. Memo 2019-14 (3/4/19). The taxpayers, a married couple, purchased health insurance for 2014 through Covered California, a health insurance exchange created under the Affordable Care Act. Based on their projected household income, they qualified for an advance payment of the premium tax credit authorized by § 36B. During 2014, the exchange made total payments to the health insurance issuer of $8,402. Generally, under §36B(c)(1), the premium tax credit is available to taxpayers whose household income is at least 100 percent but not more than 400 percent of the federal poverty line. For this purpose, § 36B(d)(2)(A) provides that household income is the sum of the modified adjusted gross income (MAGI) of the taxpayer and all family members required to file a tax return who are taken into account in determining family size. MAGI is defined in relevant part by § 36B(d)(2)(B) as adjusted gross income (AGI) increased by certain items. The AGI and MAGI for 2014 of the taxpayers, who had no dependents, was $97,061. This amount exceeded 400 percent of the federal poverty line, and therefore the taxpayers were not eligible for the § 36B premium tax credit. Because they had received advance credit payments, they were required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on their return. The taxpayers did not report their advance credit payments on their 2014 return. The IRS ultimately issued a notice of deficiency disallowing the entire credit. Because they did not qualify for any premium tax credit and had received $8,402 in advance credit payments, they owed the entire $8,402 as a tax liability. The taxpayers asserted various state law claims against the health insurance issuer (Blue Shield) and Covered California, including false advertising, unfair business practices, and breach of duty. They argued that this alleged malfeasance nullified any tax liability arising from the excess advance premium tax credit payments. The Tax Court (Judge Lauber) held that it had no ability grant relief to the taxpayers. The court relied on its prior decision in *McGuire v. Commissioner*, 149 T.C. 254 (8/28/17), for the proposition that the statutory mandate of § 36B(f)(2)(A), which provides that tax liability "shall be increased" by the amount of any excess advance premium tax credit payments, is not subject to equitable exceptions.

4. Although the Tax Court found it more likely than not that the taxpayer's compulsive gambling was a side effect of his physician-prescribed Pramipexole, his gambling losses were not casualty losses. Mancini v. Commissioner, T.C. Memo. 2019-16 (3/4/19). The taxpayer earned good money and was a successful real estate investor who gambled occasionally, but never more than $100 at a time. When he was diagnosed with Parkinson's disease, his neurologist prescribed Pramipexole (the generic name for Mirapex). Although his symptoms improved, the taxpayer started doing "odd things."

> He vacuumed a lot and became compulsive about his cleanliness. He spent a week researching and obsessing over which mattress to buy. He started falling asleep suddenly while driving. He had suicidal thoughts. And he started gambling--a lot.

Over the next two years the taxpayer depleted all of his bank accounts and all but $10,000 of his retirement savings. He also sold his real estate for less than fair market value and used the proceeds to pay gambling debts. On the taxpayer's 2008 and 2009 returns, for which he retained a return preparer, he reported gambling winnings and deducted gambling losses up to the amount of his gambling winnings. He prepared his 2019 return himself and deducted gambling losses up to the amount of his gambling winnings, and also deducted a $603,000 casualty loss for "Investment Portfolio and Home." He later amended his 2008 and 2009 returns to claim large casualty losses. The IRS issued a notice of deficiency for 2010. The Tax Court (Judge Holmes) first concluded, based on expert testimony, that it was more likely than not that the taxpayer's compulsive gambling was a side effect of the Pramipexole he was taking. Nevertheless, the court held, the taxpayer's gambling losses were not casualty losses for two reasons. First, the court reasoned, physical damage to property is a prerequisite of a casualty-loss deduction, and the taxpayer had not suffered physical damage to property. "Mancini's depleted bank accounts, and the money he left on the table when he made bad real-estate deals, didn't suffer any physical damage. Second, the manner in which casualty losses are calculated demonstrates that the taxpayer had not suffered a casualty loss. The amount of a casualty loss is the amount by which the fair market value of the property before the casualty exceeds the fair market value of the property after the casualty, reduced by the amount of any insurance proceeds recovered. In this case, the court reasoned, the taxpayer's losses occurred over three years, which is not "sudden" as required for a casualty loss, and it would be difficult or impossible to apply a before-and-after test to determine the amount of his loss because his "losses were necessarily the result of dozens or hundreds of individual gambling sessions and probably thousands of separate wagers." The court also held that, even if the losses were casualty losses, the taxpayer had failed to substantiate them. Finally the court declined to impose accuracy-related penalties under by § 6662(a) because the Service had not introduced any evidence that the penalties had been "personally approved (in writing) by the immediate supervisor of the individual making [the initial] determination" of the penalty as required by § 6751(b)(1).

E. **Divorce Tax Issues**

F. **Education**

G. **Alternative Minimum Tax**

VI. CORPORATIONS

A. **Entity and Formation**

B. **Distributions and Redemptions**

1. Now, this is "fake news" if we've ever heard it: The IRS has ruled that a redemption which does not qualify under § 302 is a distribution under § 301. Duh! Rev. Rul. 2019-13, 2019-20 I.R.B. 1179 (5/9/19). For reasons we're apparently too dense to understand, the IRS has found it necessary to rule that a redemption by a C corporation which does not qualify under § 302 is treated as a distribution under § 301. Okay, to be fair, the ruling also holds (not surprisingly) that if the C corporation's nonqualifying redemption takes place during the corporation's "post-termination transition period" (as defined in § 1377(b)) after converting from subchapter S status, the distribution reduces the former S corporation's accumulated adjustment account ("AAA") before reducing earnings and profits ("E&P") accumulated from prior C corporation years.

Facts. The facts set forth in Rev. Rul. 2019-13 are as follows: X once was a C corporation and later elected S status under § 1362(a). Then, X's S election terminated under § 1362(d), such that it is now a C corporation. A, an individual, owns all 100 shares of the outstanding stock of X. At the time of its conversion to an S corporation, X had accumulated E&P of $600x and no current E&P. At the time of the termination of its S election, X's AAA was $800x and its accumulated E&P was still $600x. During X's post-termination transition period, X redeems 50 of A's 100 shares of X stock for $1,000x. X makes no other distributions during the post-termination transition period. For the taxable period that includes the redemption, X has current E&P of $400x.

Law and Analysis: Recall that because A still owns 100 percent of the stock of X after the redemption, the transaction does not qualify for sale or exchange treatment under § 302 and therefore is treated as distribution under § 301. Further recall that the "post-termination transition period" under § 1377(b) generally is the one-year period following the termination of a corporation's subchapter S status. Under § 1371(e), any distribution of cash by a former S corporation with respect to its stock during the post-termination transition period ordinarily is applied against and reduces the adjusted basis of the recipient's stock to the extent the distribution does not exceed the corporation's AAA (within the meaning of § 1368(e)).

Held, the redemption of 50 of A's 100 shares of X stock for $1,000x is characterized as a reduction of X's $800x of AAA with the remaining $200x characterized as a dividend under § 301(c)(1).

C. **Liquidations**

D. **S Corporations**

1. A § 267 "looptrap" snares an accrual-method subchapter S corporation with an ESOP shareholder. Petersen v. Commissioner, 148 T.C. 463 (6/13/17). The taxpayers, a married couple, owned stock in an accrual-method S corporation with many employees. As permitted by § 1361(c)(7), an ESOP benefitting the employees also owned stock in the S corporation. The S corporation had accrued and deducted the following amounts with respect to its ESOP participants as of the end of its 2009 and 2010 tax years: for 2009, unpaid wages of $1,059,767 (paid by January 31, 2010) and vacation pay of $473,744 (paid by December 31, 2010); for 2010, unpaid wages of $825,185 (paid by January 31, 2011) and vacation pay of $503,896 (paid by December 31, 2011). Notwithstanding the fact that the S corporation was an accrual-method taxpayer, the IRS asserted under § 267(a)(2) (forced-matching) that the corporation was not entitled to deduct the foregoing accrued amounts until the year of actual payment and inclusion in gross income by the ESOP's cash-method, employee-participants. In a case of first impression, the Tax Court (Judge Lauber) agreed with the IRS based upon a plain reading of §§ 67(a)(2), (b), and (e), as well as a determination that the S corporation's ESOP is a "trust" within the meaning of § 267(c). Specifically, § 267(a)(2) generally requires so-called "forced matching" of an accrual-method taxpayer's deductions with the gross income of a cash-method taxpayer to whom a payment is to be made if the taxpayer and the person to whom the payment is to be made are related persons as defined by § 267(b). For an S corporation, pursuant to § 267(e), all shareholders are considered related persons under § 267(b) regardless of how much or how little stock such shareholders actually *or constructively* own. Furthermore, under § 267(c) beneficiaries of a trust are deemed to own any stock held by the trust. Because the assets held by an ESOP are owned by a trust (as required by ERISA, *see* 29 U.S.C. § 1103(a)), the participating employees of the ESOP are treated as shareholders of the S corporation. Hence, the forced-matching rule of § 267(a)(2) applies to accrued but unpaid wages and vacation pay owed to the S corporation's ESOP participants at the end of the year. Judge Lauber noted that this odd situation probably was a "drafting oversight"—in our words, a *looptrap*—because § 318, which defines related parties for certain purposes under subchapter C, excepts tax-exempt employee trusts from its constructive ownership rules. Nevertheless, Judge Lauber wrote, the Tax Court is "not at liberty to revise section 267(c) to craft an exemption that Congress did not see fit to create." Mercifully, however, the Tax Court declined to impose § 6662 negligence or substantial understatement penalties on the taxpayers because the case was one where "the issue was one not previously considered by the Court and the statutory language was not clear" (even though the court obviously relied upon the plain language of § 267 to reach its decision).

a. This accrual-method S corporation was properly snared, says the Tenth Circuit. Petersen v. Commissioner, 924 F.3d 1111 (10th Cir. 5/15/19), *aff'g* 148 T.C. 463 (6/13/17). In an opinion by Judge Hartz, the U.S. Court of Appeals for the Tenth Circuit has affirmed the Tax Court's decision that an accrual-method S corporation's deductions for amounts payable to cash-method participants in an ESOP that held shares of the S corporation were deferred by the forced matching rule of § 267(a)(2). Section 267(a)(2) provides that the deductions of an accrual-method taxpayer for amounts payable to a related cash-method taxpayer must be deferred until the year in which the amounts are included in the related taxpayer's gross income. Under § 267(c), beneficiaries of a trust are treated as constructively owning any stock held by the trust. Further, under § 267(e), all shareholders of an S corporation are treated as "related persons" within the meaning of § 267(b) regardless of how much or how little stock such shareholders actually *or constructively* own. The Tenth Circuit agreed with the Tax Court that the effect of these provisions is that employees of an S corporation who participate in an ESOP that holds shares of the S corporation are "related persons" with respect to the S corporation within the meaning of § 267(b), and therefore an accrual-method S corporation's deductions for amounts payable to such employees are subject to deferral under the forced-matching rule of § 267(a)(2). In reaching this conclusion, the court rejected several arguments made by the taxpayers and held that an ESOP is a "trust" within the meaning of § 267(c), and therefore the ESOP's participants are treated as constructively holding proportionately the stock held by the ESOP.

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

VII. PARTNERSHIPS

A. Formation and Taxable Years

B. Allocations of Distributive Share, Partnership Debt, and Outside Basis

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

1. Relief for not reporting negative tax capital accounts. Notice 2019-20, 2019-14 I.R.B. 927 (3/7/19). The updated 2018 Instructions for Form 1065 and accompanying Schedule K-1 now require a partnership that does not report tax basis capital accounts to its partners to report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner's tax basis capital both at the beginning of the year and at the end of the year if either amount is negative. Aware that some taxpayers and their advisors may not have been prepared to comply with this new requirement for 2018 returns, the IRS, in Notice 2019-20, has provided limited relief. Specifically, the IRS will waive penalties (1) under § 6722 for failure to furnish a partner a Schedule K-1 (Form 1065) and under § 6698 for failure to file a Schedule K-1 (Form 1065) with a partnership return, (2) under § 6038 for failure to furnish a Schedule K-1 (Form 8865), and (3) under any other section of the Code for failure to file or furnish a Schedule K-1 or any other form or statement, for any penalty that arises solely as a result of failing to include negative tax basis capital account information provided the following conditions are met:

1. The Schedule K-1 or other applicable form or statement is timely filed, including extensions, with the IRS; is timely furnished to the appropriate partner, if applicable; and contains all other required information.
2. The person or partnership required to file the Schedule K-1 or other applicable form or statement files with the IRS, no later than one year after the original, unextended due date of the form to which the Schedule K-1 or other applicable form or statement must be attached, a schedule setting forth, for each partner for which negative tax basis capital account information is required: (a) the partnership's name and Employer Identification Number, if any, and Reference ID Number, if any; (b) the partner's name, address, and taxpayer identification number; and (c) the amount of the partner's tax basis capital account at the beginning and end of the tax year at issue.

The above-described supplemental schedule should be captioned "Filed Under Notice 2019-20" in accordance with instructions and additional guidance posted by the IRS on www.IRS.gov. The due date for this supplemental schedule is determined without consideration of any extensions, automatic or otherwise, that may apply to the due date for the form itself. Furthermore, the schedule should be sent to the address listed in the Notice, and the penalty relief applies only for taxable years beginning after December 31, 2017, but before January 1, 2019.

a. The IRS has issued FAQ guidance on negative tax basis capital account reporting. The IRS has issued guidance on the requirement to report negative tax basis capital account information in the form of frequently asked questions (FAQs) on its website. The FAQs are available at https://www.irs.gov/businesses/partnerships/form-1065-frequently-asked-questions.

Definition and calculation of tax basis capital accounts. In the FAQs, the IRS explains that "[a] partner's tax basis capital account (sometimes referred to simply as 'tax capital') represents its equity as calculated using tax principles, not based on GAAP, § 704(b), or other principles." The FAQs provide guidance on the calculation of a partner's tax basis capital account. A partner's tax basis capital account is *increased by the amount of money and the adjusted basis of any property contributed* by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) and is *decreased by the amount of money and the adjusted basis of any property distributed by the partnership to the partner* (less any liabilities assumed by the partner or to which the property is subject). The partner's tax basis capital account is increased by certain items, such as the partner's distributive share of partnership income and gain, and is decreased by certain items, such as the partner's distributive share of partnership losses and deductions. The FAQs make clear that a partner's tax basis capital account is not the same as a partner's basis in the partnership interest (outside basis) because outside basis includes the partner's share of partnership liabilities, whereas a partner's tax basis capital account does not.

Effect of § *754 Elections and Revaluations of Partnership Property*. If a partnership has a § 754 election in effect, then it increases or decreases the adjusted basis of partnership property pursuant to § 743(b) when there is a transfer of a partnership interest or pursuant to § 734(b) when there is a distribution by the partnership. These adjustments can also be triggered when the partnership does not have a § 754 election in effect but has a substantial built-in loss and a transfer of a partnership interest occurs (§ 743(b) basis adjustment) or experiences a substantial basis reduction in connection with a distribution (§ 734(b) basis adjustment). The FAQs clarify that a partner's tax basis capital account *is increased or decreased by a partner's share of basis adjustments under § 743(b) and § 734(b).* In contrast, according to the FAQs, *revaluations of partnership property* pursuant to § 704 (such as upon the entry of a new partner) *do not affect the tax basis of partnership property or a partner's tax basis capital account.*

Examples. The FAQs provide the following examples of the calculation of a partner's tax basis capital account:

> *Example 1:* A contributes $100 in cash and B contributes unencumbered, nondepreciable property with a fair market value (FMV) of $100 and an adjusted tax basis of $30 to newly formed Partnership AB. A's initial tax basis capital account is $100 and B's initial tax basis capital account is $30.
>
> *Example 2:* The facts are the same as in Example 1, except B contributes nondepreciable property with a FMV of $100, an adjusted tax basis of $30, and subject to a liability of $20. B's initial tax basis capital account is $10 ($30 adjusted tax basis of property contributed, less the $20 liability to which the property was subject).
>
> *Example 3:* The facts are the same as in Example 1, except in Year 1, the partnership earns $100 of taxable income and $50 of tax-exempt income. A and B are each allocated $50 of the taxable income and $25 of the tax-exempt income by the partnership. At the end of Year 1, A's tax basis capital account is increased by $75, to $175, and B's tax basis capital account is increased by $75, to $105.
>
> *Example 4:* The facts are the same as in Example 3. Additionally, in Year 2, the partnership has $30 of taxable loss and $20 of expenditures which are not deductible in computing partnership taxable income and which are not capital expenditures. A and B are each allocated $15 of the taxable loss and $10 of the expenditures which are not deductible in computing partnership taxable income and which are not capital expenditures. At the end of Year 2, A's tax basis capital account is decreased by $25, to $150, and B's tax basis capital account is decreased by $25, to $80.
>
> *Example 5:* On January 1, 2019, A and B each contribute $100 in cash to a newly formed partnership. On the same day, the partnership borrows $800 and purchases Asset X, qualified property for purposes of §168(k), for $1,000. Assume that the partnership properly allocates the $800 liability equally to A and B under §752. Immediately after the partnership acquires Asset X, both A and B have tax basis capital

accounts of $100 and outside bases of $500 ($100 cash contributed, plus $400 share of partnership liabilities under §752). In 2019, the partnership recognizes $1,000 of tax depreciation under §168(k) with respect to Asset X; the partnership allocates $500 of the tax depreciation to A and $500 of the tax depreciation to B. On December 31, 2019, A and B both have tax basis capital accounts of negative $400 ($100 cash contributed, less $500 share of tax depreciation) and outside bases of zero ($100 cash contributed, plus $400 share of partnership liabilities under § 752, and less $500 of share tax depreciation).

Tax Basis Capital Account of a Partner Who Acquires the Partnership Interest from Another Partner. A partner who acquires a partnership interest from another partner, such as by purchase or in a non-recognition transaction, has a tax basis capital account immediately after the transfer equal to the transferring partner's tax basis capital account immediately before the transfer with respect to the portion of the interest transferred. However, any §743(b) basis adjustment the transferring partner may have is not transferred to the acquiring partner. Instead, if the partnership has a §754 election in effect, the tax basis capital account of the acquiring partner is increased or decreased by the positive or negative adjustment to the tax basis of partnership property under §743(b) as a result of the transfer.

Safe Harbor Method for Determining a Partner's Tax Basis Capital Account. The FAQs provide a safe harbor method for determining a partner's tax basis capital account. Under this method, "[p]artnerships may calculate a partner's tax basis capital account by subtracting the partner's share of partnership liabilities under §752 from the partner's outside basis (safe harbor approach). If a partnership elects to use the safe harbor approach, the partnership must report the negative tax basis capital account information as equal to the excess, if any, of the partner's share of partnership liabilities under §752 over the partner's outside basis."

Certain partnerships are exempt from reporting negative tax basis capital accounts. Partnerships that satisfy four conditions (those provided in question 4 on Schedule B to Form 1065) do not have to comply with the requirement to report negative tax basis capital account information. This is because a partnership that satisfies these conditions is not required to complete item L on Schedule K-1. The four conditions are: **(1)** the partnership's total receipts for the tax year were less than $250,000; **(2)** the partnership's total assets at the end of the tax year were less than $1 million; **(3)** Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return; and **(4)** the partnership is not filing and is not required to file Schedule M-3.

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

B. Charitable Giving

1. It took some time, but finally we "gotcha," says the IRS, in this infamous charitable contribution case involving billionaire and Miami Dolphins' owner Stephen Ross and the University of Michigan. RERI Holdings I, LLC v. Commissioner, 149 T.C. 1 (7/3/17). In a TEFRA case that has gone on for some time and has produced at least one other noteworthy holding (see below), the IRS prevailed in denying a $33 million charitable contribution deduction to a partnership in which Stephen Ross, owner of the Miami Dolphins, was a partner. The property was donated to the University of Michigan, Mr. Ross's alma mater. The partnership had paid only $2.95 million for the property a little over a year prior to its donation. In fact, at some point after the donation the University of Michigan sold the property for only $1.94 million. These facts, of course, displeased the IRS greatly, and the IRS convinced the Tax Court to deny the partnership's charitable contribution deduction on technical grounds (as discussed below). Moreover, contrary to decisions of the Fifth and Ninth Circuits, the Tax Court (Judge Halpern) determined that the partners of the partnership potentially are liable for aggregate gross valuation misstatement penalties of about $11.8 million.

The facts of the case are complicated, but essentially reveal that for tax year 2003 the partnership claimed a $33 million charitable contribution deduction under § 170(a)(1) for a donation to the University of Michigan. The donated property consisted of a remainder interest in a disregarded single-member LLC that the partnership owned and that held underlying real property. On its Form 8283, Noncash Charitable Contributions, the partnership failed to report its "cost or adjusted basis" for the donated property as required by Reg. § 1.170A-13(c)(4)(ii)(E), instead leaving the line on the form completely blank. Judge Halpern ruled that this failure to comply either strictly or substantially with the regulations is fatal to a claimed charitable contribution deduction, thereby denying the deduction in full. Lastly, for purposes of determining potential penalties, the Tax Court held that the correct value of the property at the time of the donation was approximately $3.5 million.

Regarding the IRS's assertion of the 40 percent penalty under § 6662(h) for "gross valuation misstatements" (valuation of 400 percent or more of correct value), the partnership argued that § 6662 should not apply because the $33 million charitable contribution deduction was completely disallowed and hence was not "attributable to" a valuation misstatement. *See, e.g.*, *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), *rev'g* T.C. Memo. 1988-408; *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990), *aff'g* T.C. Memo. 1988-416. Judge Halpern's opinion, however, relies upon the Tax Court's more recent decision in *AHG Investments, LLC v. Commissioner*, 140 T.C. 73 (2013), in which the court declined to follow *Heasley* and *Gainer*. Judge Halpern noted that both the Fifth and Ninth Circuits have expressed reservations about *Heasley* and *Gainer*, and because any appeal by the partnership (due to its dissolution in 2004) would be to the U.S. Court of Appeals for the Federal Circuit, the Tax Court was free to follow its decision in *AHG Investments*. Judge Halpern then determined that the correct fair market value of the donated property should have been roughly $3.5 million, i.e., $29.5 million less than the value claimed by the partnership. Therefore, subject to partner-level § 6662(e)(2) calculations ($5,000 underpayment threshold per partner), the partners of the partnership potentially are liable for penalties aggregating as much as $11.8 million (40 percent of the $29.5 million valuation overstatement).

- The IRS probably thought it should have won this case previously on a similar technicality. In *RERI Holdings I, LLC v. Commissioner*, 143 T.C. 41 (2014), the IRS had cleverly argued on a summary judgment motion that the partnership's "qualified appraisal" (*see* § 170(f)(11)) of the property was fatally flawed. Specifically, the IRS had argued that although the partnership obtained an otherwise qualified appraisal, the partnership's appraisal valued a remainder interest in the underlying real property, not the remainder interest in the disregarded single-member LLC that held the real property. The remainder interest in the disregarded single-member LLC was the property the partnership donated to the University of Michigan, not the real property itself. Thus, argued the IRS, the partnership's otherwise qualified appraisal was for *the wrong property* (even though under § 7701 the single-member LLC was completely disregarded for all other tax purposes)! But, in 2014 Judge Halpern did not let the IRS win so easily. Judge Halpern accepted the IRS's argument that a charitable contribution of an interest in a disregarded single-member LLC should be viewed differently (and perhaps valued differently) than a charitable contribution of the underlying asset(s). Judge Halpern so held even while acknowledging that a single-member LLC otherwise is ignored for federal tax purposes. Judge Halpern's opinion relied heavily on the Tax Court's earlier decision in a gift tax case involving a disregarded single-member LLC. *See Pierre v. Commissioner*, 133 T.C. 24 (2009), *supplemented by* T.C. Memo. 2010-106. Nevertheless, perhaps to avoid so-easily granting summary judgment against the taxpayer and in favor of the IRS in 2014, Judge Halpern reasoned that there was an unresolved issue of material fact whether a valuation of the real property held by the partnership's disregarded single-member LLC could "stand proxy" for the otherwise required "qualified appraisal." Surprisingly, though, Judge Halpern's decision in the earlier *RERI* ruling raises the prospect of a disregarded single-member LLC interest being regarded and valued separately for purposes of determining charitable contributions under § 170.

a. Fumble? Touchdown IRS? Game over? Pick your pun, but it might be time for this taxpayer to admit defeat. Fiddlesticks!!! RERI Holdings I, LLC v. Commissioner, 924 F.3rd 1261 (Fed. Cir. 5/24/19). The Court of Appeals for the Federal Circuit (Judge Ginsburg) has affirmed the holding of the Tax Court that the taxpayer's failure to report its "cost or adjusted basis" for donated property on Form 8283, Noncash Charitable Contributions, as required by Reg. § 1.170A-13(c)(4)(ii)(E), is fatal to the taxpayer's claimed $33 million charitable contribution deduction. The Court of Appeals for the Federal Circuit also upheld the Tax Court's imposition of a 40 percent gross valuation misstatement penalty under § 6662(h) even though the claimed charitable contribution deduction ultimately was disallowed. After summarizing the facts and procedural posture of the case, the Federal Circuit explained that, even assuming for the sake of argument that the requirements of Reg. § 1.170A-13(c)(4)(ii)(E) can be met by substantial compliance as the taxpayer had claimed in the Tax Court and on appeal, the taxpayer had not in fact substantially complied with the regulations because it left a blank line on the Form 8283 instead of providing any information whatsoever as to its cost or adjusted basis in the donated property. The Federal Circuit also rejected all four of the taxpayer's arguments (one of which was new) and upheld the Tax Court's imposition of the 40 percent gross valuation misstatement penalty under § 6662(h). With regard to this latter ruling upholding the Tax Court, the Federal Circuit reasoned as follows. *First*, the taxpayer argued *de novo* that the IRS failed to obtain the supervisory approval required under § 6751(b) before imposing a penalty under § 6662. *See Chai v. Commissioner*, 851 F.3d 190 (2017). The Federal Circuit rejected this new argument by the taxpayer, however, because the argument had not been raised previously in the Tax Court (notwithstanding the fact that *Chai* had not been decided at the time the taxpayer was before the Tax Court). Responding to the taxpayer's contention that it did not raise the argument in Tax Court because *Chai* had not been decided and the Tax Court's prior position at the time was that supervisory approval was not required under § 6751(b) until assessment, *see Graev v. Commissioner*, 147 T.C. 460 (2016) *supplemented and overruled in part by Graev v. Commissioner*, 149 T.C. 485 (2017), the Federal Circuit wrote: "Fiddlesticks. The fact is that when RERI was before the Tax Court, it 'was free to raise the same, straightforward statutory interpretation argument the taxpayer in *Chai* made' there." *Second*, the Federal Circuit agreed with the Tax Court's rejection of the taxpayer's "attributable to" argument which previously had been addressed by Judge Halpern. *Third*, the Federal Circuit rejected the taxpayer's argument that Judge Halpern failed to properly value the donated property for purposes of determining the gross valuation misstatement penalty. *Finally*, the Federal Circuit rejected the taxpayer's argument that it had met the "reasonable cause" exception for avoiding the gross valuation misstatement penalty of § 6662(h). Judge Halpern similarly had ruled that the taxpayer did not meet the "reasonable cause" exception; however, Judge Halpern concluded the IRS had met its burden of proof under Rule 142 that reasonable cause was lacking whereas the Federal Circuit reasoned that, regardless, the taxpayer did not show reasonable cause and did not qualify for the exception irrespective of whether the IRS must show a lack of reasonable cause under Rule 142.

2. Personally evangelizing for "BSDM" — pay attention; we didn't write "BDSM" — doesn't allow you to take charitable contribution deductions for your unreimbursed expenses. Oliveri v. Commissioner, T.C. Memo 2019-57 (5/28/19). Although expenses incurred "for the use of" a charitable organization can be deductible under § 170, the Tax Court held that this taxpayer took things a little too far. (Sometimes you really can't help but wonder, "What were they thinking?" when reading certain Tax Court cases. This is one of those cases.) The taxpayer was a former U.S. Air Force pilot who upon his retirement from the Air Force became very active in the Catholic Church. The taxpayer frequently attended church-related meetings, participated in community outreach efforts, and assisted various church officials. In 1987, the taxpayer was certified as a teacher and trainer for the Catholic Church following his completion of a 16-week Catholic evangelization trainer's program. Since that time, the taxpayer has devoted his life to evangelism on behalf of the Catholic Church. The taxpayer considered all of his contact with the public an opportunity for evangelism, and he would wear a large and visible crucifix at all times. The taxpayer evangelized and discussed his faith with friends, members of his extended family, and members of the religious organization that he founded, The Brothers and Sisters of the Divine Mercy ("BSDM"). (*No, we're not kidding. The acronym used by the Tax Court really was "BSDM."*) The taxpayer incurred significant expenses in connection with his BSDM and Catholic Church evangelism activities in 2012, including costs for piloting and flying a leased airplane, commercial airfare, other transportation, lodging, meals, gifts for needy individuals and members of BSDM, etc. The taxpayer's 2012 unreimbursed expenses in this regard totaled at least $39,979, all of which he deducted as charitable contributions. None of the taxpayer's activities or expenses, however, were expressly authorized by the Catholic Church, and the Catholic Church did not provide the taxpayer with contemporaneous written acknowledgments for his expenses. After restating the general rule that to be deductible under § 170 unreimbursed expenses must be subject to coordination, supervision, or oversight by a charitable organization, *see Van Dusen v. Commissioner*, 136 T.C. 515 (2011), the Tax Court (Judge Colvin) had little trouble denying the taxpayer's claimed deductions in this case. The Tax Court reasoned that not only did the unreimbursed expenses fail to meet the *Van Dusen* standard, but most of the taxpayer's expenses were incurred in whole or in part for personal purposes. Furthermore, with respect to unreimbursed expenses of $250 or more attendant to rendering services on behalf of a charity, a taxpayer must obtain a contemporaneous written acknowledgment to comply with Reg. § 1.170A-13(f)(10). The taxpayer did not, even from BSDM, the organization he founded. Perhaps, though, divine intervention did play a role in this case. The Tax Court held that the IRS could not impose accuracy-related penalties against the taxpayer because prior, written supervisory approval had not been obtained as required by § 6751(b)(1). *See Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017); *Graev v. Commissioner*, 149 T.C. 485 (2017).

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

1. The common-law mailbox rule has been displaced by regulations, says the Ninth Circuit. Baldwin v. United States, 921 F.3d 836 (9th Cir. 4/16/19). The taxpayers, a married couple, filed a return for 2007 that reflected a net operating loss. They wished to carry this loss back to 2005 and, under the relevant statutory provisions (§ 6511(b)(1), (d)(2)(A)), in order to obtain a refund of taxes paid with respect to 2005, were required to file a claim for refund by October 5, 2011. The taxpayers asserted that they had filed an amended return seeking a refund for 2005 in June 2011. The IRS, however, never received that amended return. The IRS did receive an amended return for 2005 from the taxpayers in 2013, after the limitations period for seeking a refund had expired, and the IRS therefore denied their refund claim. The taxpayers brought this action for a refund in the U.S. District Court. Under § 7422(a), the jurisdiction of both U.S. District Courts and the U.S. Court of Federal Claims to hear tax refund actions is limited to those cases in which the taxpayer has "duly filed" a claim for refund with the Service. The issue in this case was how the taxpayers could prove that they had filed the necessary timely refund claim. Under the common-law mailbox rule developed and applied by some courts,

> proof of proper mailing—including by testimonial or circumstantial evidence—gives rise to a rebuttable presumption that the document was physically delivered to the addressee in the time such a mailing would ordinarily take to arrive.

At trial, the taxpayers introduced the testimony of two of their employees, who testified that they had deposited the amended 2005 return in the mail at the post office in Hartford, Connecticut, on June 21, 2011. The District Court credited the testimony of the two employees, applied the common-law mailbox rule, and held that the taxpayers were entitled to a refund of approximately $167,000 plus litigation costs of $25,000. In an opinion by Judge Watford, the U.S. Court of Appeals for the Ninth Circuit reversed. The common-law mailbox rule, the court held, has been displaced by § 7502. Under § 7502(a), the postmark stamped on the cover in which a return or claim is mailed is deemed to be the date of delivery if the return or claim (1) is deposited in the mail in the United States within the time prescribed for filing in a properly addressed, postage prepaid envelope or other appropriate wrapper and bears a postmark date that falls within the time prescribed for filing, and (2) is delivered by United States mail after the prescribed time for filing to the agency with which it is required to be filed. The statute also provides that, if the return or claim is mailed by United States registered mail, the date of registration is treated as the postmark date and the registration is prima facie evidence that the return or claim was delivered to the agency to which it was addressed. Section 7502(c)(2) authorizes the Secretary of the Treasury to issue regulations providing the same treatment of returns or claims sent by certified mail, which Treasury and the IRS have done. *See* Reg. § 301.7502-1(c)(2). Section 301.7502-1(e)(2)(i) of the regulations further provides that, except for direct proof of actual delivery, proof of proper use of registered or certified mail (or a designated private delivery service) is the *exclusive means* to establish prima facie evidence of delivery and that "[n]o other evidence of a postmark or of mailing will be prima facie evidence of delivery or raise a presumption that the document was delivered." The Ninth Circuit 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, § 7502, is silent as to whether it displaces the common-law mailbox rule with respect to items sent by regular mail, and in step two that Reg. § 301.7502-1(e)(2)(i) is a permissible interpretation of the statute. Accordingly, the court deferred to the regulatory interpretation of the statute and held that, because § 7502 displaces the common-law mailbox rule, the taxpayers could not rely on the testimony of their employees to raise a presumption that their refund clam was delivered.

- The Ninth Circuit previously had held in *Anderson v. United States*, 966 F.2d 487 (9th Cir. 1992), that § 7502 did not displace the common-law mailbox rule. Despite that prior decision, the court upheld the validity of the regulation by applying the rule of *National Cable & Telecomm. Association v. Brand X Internet Services*, 545 U.S. 967 (2005), which held that a court's prior judicial construction of a statute trumps an agency construction that is entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and leaves no room for agency discretion. The Ninth Circuit's decision in *Anderson* did not express such a holding. Prior to Treasury's issuance of Reg. § 301.7502-1(e)(2)(i), other federal courts of appeal had split on the issue whether § 7502 displaced the common-law mailbox rule. It seems likely that, if the issue arises in these courts with respect to a year subject to the regulation, they will follow the Ninth Circuit in giving *Chevron* deference to the regulation.

F. Liens and Collections

1. "The Freak" might no longer have a 40-inch vertical leap, but he managed to take down the IRS's notice of federal tax lien following a collection due process hearing on the basis that the Appeals Officer did not properly verify mailing of the notice of deficiency. Kearse v. Commissioner, T.C. Memo. 2019-53 (5/20/19). The taxpayer in this case, Jevon Kearse, who played for more than a decade in the NFL for the Tennessee Titans and the Philadelphia Eagles, took a business bad debt deduction of $1.36 million on his 2010 federal income tax return. The IRS disallowed the deduction and assessed tax in the amount of more than $400,000. In response to the IRS's notice of federal tax lien, the taxpayer requested a collection due process hearing. In the CDP hearing, the taxpayer submitted an offer in compromise based on doubt as to liability and offered to pay $1. He disputed the IRS's proper mailing and his receipt of the statutory notice of deficiency. The IRS Appeals Office issued a notice of determination sustaining the collection action, and the taxpayer sought review by filing a petition in the Tax Court. The Tax Court (Judge Ashford) held that it was an abuse of discretion for the IRS Appeals Officer to sustain the collection action. Sections 6320(c) and 6330(c) require the Appeals Officer conducting the CDP hearing to verify that the requirements of applicable law and administrative procedure have been met. The Appeals Officer was unable to secure United States Postal Service From 3877 to show proof of mailing of the notice of deficiency. She also did not request the statutory notice of deficiency. She instead examined the IRS's Integrated Data Retrieval System (IDRS) to verify that the notice of deficiency had been mailed. In the Tax Court, the IRS stipulated that the IRS was unable to produce USPS Form 3877. The court held that "the Appeals officer had failed to properly perform the verification mandated by section 6330(c), i.e., to properly verify that the assessment of petitioner's 2010 income tax liability was preceded by a duly mailed notice of deficiency." Specifically, the court stated:

> Where a taxpayer alleges that the notice of deficiency was not properly mailed to him, he has "alleged an irregularity" … thereby requiring the Appeals officers, according to further IRS guidance, to do more than "rely solely" on IDRS; they must review: (1) a copy of the notice of deficiency and (2) the USPS Form 3877 or equivalent IRS certified mail list bearing a USPS stamp or the initials of a postal employee. …[T]he Appeals officer here acknowledges that she did not secure (and accordingly review) either of these documents before the notice of determination was issued to petitioner.

The court also rejected the IRS's belated production of USPS Form 3877 because the IRS had stipulated that it could not produce this form.

G. Innocent Spouse

H. Miscellaneous

1. The D.C. Circuit has reversed a federal district court and held that the IRS can charge fees for issuing PTINs. Montrois v. United States, 916 F.3d 1056 (D.C. Cir. 3/1/19). A group of tax return preparers filed a class action lawsuit in a U.S. District Court challenging the IRS's practice of charging a fee for issuing preparer tax identification numbers (PTINs). The tax return preparers argued that the IRS lacked authority under the Independent Offices Appropriations Act to charge a fee for issuing and renewing PTINs and that the IRS's decision to charge fees was arbitrary and capricious in violation of the Administrative Procedure Act. The U.S. District Court held that, although the IRS had statutory authority to require the use of PTINs by those who prepare tax returns for compensation, it lacked legal authority to charge fees for issuing PTINs. *Steele v. United States*, 119 A.F.T.R.2d 2017-2065 (D.D.C. 2017). The U.S. District Court declared all fees charged by the IRS for issuing PTINs unlawful, permanently enjoined the United States from charging such fees, and ordered the United States to refund all PTIN fees paid from September 1, 2010 to the present. *Steele v. United States*, 120 A.F.T.R. 2d 2017-5145 (D.D.C. 2017). The government appealed the U.S. District Court's decision to the U.S. Court of Appeals for the District of Columbia Circuit. In an opinion by Judge Srinivasan, the D.C. Circuit reversed the District Court's decision. As discussed in more detail below, the court held that the IRS acted within its authority under the Independent Offices Appropriations Act in charging tax return preparers a fee to obtain and renew PTINs and also concluded that the IRS's decision to charge a fee was not arbitrary and capricious. The court remanded the case to the U.S. District Court for further proceedings, including a determination of whether the amount of the PTIN fee unreasonably exceeds the costs to the IRS to issue and maintain PTINs.

The Independent Offices Appropriations Act provides the IRS with legal authority to charge a fee for issuing PTINs. The D.C. Circuit reviewed its own prior decisions and those of the U.S. Supreme Court and, based on this review, reasoned that the Independent Offices Appropriations Act does not authorize federal agencies to tax, which is a legislative power, but rather to impose reasonable fees for benefits conferred on identifiable beneficiaries. According to the court, "[t]o justify a fee under the [Independent Offices Appropriations] Act, then, an agency must show (i) that it provides some kind of service in exchange for the fee, (ii) that the service yields a specific benefit, and (iii) that the benefit is conferred upon identifiable individuals." The IRS, the court concluded, had met all of these requirements with respect to the fee charged for issuing a PTIN. The service provided by the IRS is the issuance of the PTIN, a unique identifying number for each tax-return preparer, and the maintenance of the database of PTINs, which enables preparers to use those numbers in place of their Social Security numbers on tax returns. This service yields a specific benefit, the court concluded, because it protects a tax-return preparer's identity by allowing the preparer to list the PTIN on returns rather than the preparer's social security number. The court also determined that this benefit is conferred upon identifiable individuals because tax-return preparers qualify as identifiable recipients for this purpose. Although practically anyone can obtain a PTIN, the benefit of PTINs is conferred upon identifiable individuals (those who apply for them), just as the benefit of the State Department's fee for issuing a passport is conferred upon identifiable individuals (those who apply for passports).

The IRS's decision to charge a fee for issuing PTINs was not arbitrary and capricious. Under relevant provisions of the Administrative Procedure Act, 5 U.S.C. § 706(2)(A), an agency's decision must be the product of reasoned decision-making. The tax return preparers challenging the PTIN fees argued that this requirement was not met because the 2010 regulations that originally established the PTIN fee stated that the fee would pay for the registered tax-return preparer program, which was ruled invalid in *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014). The D.C. Circuit held, however, that the IRS had given adequate reasons for its decision to impose a fee independent of those rejected in *Loving*. Specifically, the court stated, "[w]hen the IRS reissued the PTIN fee regulations after *Loving*, it explained that PTINs would benefit preparers by protecting their confidential information and would improve tax compliance and administration."

- On May 24, 2019, the tax return preparers who challenged the IRS's ability to charge fees for issuing PTINs filed a petition for a writ of certiorari with the U.S. Supreme Court. The petition asks the Court to review the decision of the U.S. Court of Appeals for the District of Columbia

Circuit. *Montrois v. United States*, Docket No. 18-1493 (U.S. 5/24/19).

2. Another lesson on mailing a petition to the Tax Court: the date printed on a postage label purchased through the internet will be disregarded if the envelope also bears a U.S. Postal Service postmark. Jordan v. Commissioner, T.C. Memo. 2019-15 (3/4/19). The last day for the taxpayer to file a Tax Court petition was March 6, 2018. The taxpayer, who represented herself, printed a label from Endicia.com, an online postage provider, dated March 6, 2018. The envelope containing the petition also bore two U.S. Postal Service postmarks dated March 7 and March 20, 2018. The Tax Court received and filed the petition on March 26, 2018 which was twenty days after the date shown on the Endicia.com label. The Tax Court (Judge Buch) 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 nearing U.S. postmarks].

The court noted that, in *Pearson v. Commissioner*, 149 T.C. 424 (11/29/17), a majority of the court had held that internet-purchased postage may qualify as a postmark not made by the U.S. Postal Service under § 7502(b). Because the envelope with the taxpayer's petition bore a private postmark of March 6, 2018, and later U.S. Postal Service postmarks, the court gave effect to the U.S. Postal Service postmarks. Because both of the U.S. Postal Service postmarks were dated after the last day of the 90-day period for filing a petition with the Tax Court, the court granted the government's motion to dismiss for lack of jurisdiction. The court further held that, even if it were to give effect to the March 6 date of the private postmark, it would still have to dismiss for lack of jurisdiction because, under Reg. § 301.7502-1(c)(1)(iii)(B)(1)(ii), in order to treat the date on a private postmark as the date of mailing for purposes of the timely-mailed-is-timely-filed rule, the item must have been 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. In this case, the court noted, "[a]ccording to USPS delivery standards, an item sent by First Class mail from Detroit should arrive in Washington, D.C., in three days," but the taxpayer's petition had arrived twenty days after the date of the private postmark.

- For a case in which the envelope sent by the taxpayer bore only a private postmark and the taxpayer prevailed, see *Tilden v. Commissioner*, 846 F.3d 882 (7th Cir. 1/13/17), *rev'g* T.C. Memo 2015-188 (9/22/15).

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

B. Self-employment Taxes

1. An author's trade or business included both writing and developing her brand and therefore all income she received under publishing contracts, including any portion paid for her name and likeness, was subject to self-employment tax. Slaughter v. Commissioner, T.C. Memo. 2019-65 (6/4/19). Karin Slaughter, an author of crime fiction, worked since the 1990s to establish herself as a "brand author," one who provides prestige or reliable profits to a publishing house. She worked with an agent to obtain a contract with a New York publishing house and with a media coach and publishers to develop her name and likeness into a successful brand. During the years in question, 2010 and 2011, she spent 12 to 15 weeks writing in Georgia, her state of residence, and also "spent time meeting with publishers, agents, media contacts, and others to protect and further her status as a brand author." During 2010 and 2011, she received two types of payments under contracts she had entered into during the years 1999 through 2011: nonrefundable advance payments and royalties based on the sales generated by her manuscripts. The contracts gave the publishers not only the right to print, publish, distribute, sell, and license the works and manuscripts written by the taxpayer, but also the right to use her name and likeness in advertising, promotion, and publicity for the contracted works and the right to advertise other works in her books. The publishing contracts also required the taxpayer to provide photographs and appear at promotional events and contained various forms of noncompete clauses. The publishing contracts did not allocate the taxpayer's compensation in any way, i.e., did not specify a portion allocable to acquiring the right to print, publish, and license her works and did not specify a portion allocable to acquiring the right to use her name and likeness.

On her 2010 and 2011 federal income tax returns, the taxpayer deducted as business expenses the cost of leasing a vehicle to attend media interviews and promotional events, the cost of hosting her own promotional events, and the rent she paid on an apartment in New York City, which she maintained to facilitate her professional activities there. The taxpayer's federal income tax returns for 2010 and 2011 were prepared by a CPA who concluded that the taxpayer's earned income was the compensation she received for actually writing but that any income she received under the contracts beyond compensation for writing was paid for use of her name and likeness, which was "payment for an intangible asset beyond that of her trade or business as an author" and therefore not subject to self-employment tax. On the taxpayer's 2010 and 2011 returns, all of the advances and royalties she received were reported on Schedule E, Supplemental Income and Loss, and the portion relating to her trade or business of writing was subtracted and reported on Schedule C, Profit or Loss from Business. The CPA who prepared Ms. Slaughter's returns allocated her advance payments and royalties to Schedule C based on the portion of the year that she told the CPA was the amount of time she spent writing, which was 12 to 15 weeks. The 2010 and 2011 returns took the position that only the portion of the advance payments and royalties allocated to Schedule C was subject to self-employment tax. The IRS argued that all of Ms. Slaughter's income was directly or indirectly tied to the selling of her books and therefore was subject to self-employment tax.

The Tax Court (Judge Wells) held that the taxpayer's brand was part of her trade or business and that all of her income under the publishing contracts therefore was subject to self-employment tax. The court reasoned that she had devoted significant efforts over many years to develop her brand. These efforts included meeting with publishers, agents, media contacts, and others to protect and further her status as a brand author, attending interviews and promotional events, and using social media, websites, and a newsletter to maintain her brand with her readership. The court concluded that "[s]uch sales-focused work is sufficiently routine that we consider it part of petitioner's trade or business." The court also reasoned that the taxpayer's treatment of her expenses on the returns supported treating payments received for her brand as part of her trade or business. She had deducted as business expenses the cost of leasing a vehicle to attend media interviews and promotional events, the cost of hosting her own promotional events, and the rent she paid on an apartment in New York City. The court concluded that, if brand-related expenditures are deductible on Schedule C, then the income derived from the brand is also income derived from a trade or business. The court declined to impose accuracy-related penalties for negligence or disregard of rules or regulations because she reasonably relied in good faith on a professional adviser. The court reasoned that she had satisfied the three factors required to establish a reasonable cause defense: (1) the adviser was a competent professional with sufficient expertise to justify reliance because the adviser was a CPA with many decades of experience; (2) the taxpayer had provided necessary and accurate information to the preparer; and (3) the taxpayer, who had no background in finance, law, or tax, actually relied in good faith on the preparer's judgment.

2. Partners are self-employed, even if they are employees of a disregarded entity owned by the partnership. T.D. 9869, Self-Employment Tax Treatment of Partners in a Partnership That Owns a Disregarded Entity, 84 F.R. 3178 (7/2/19). Treasury and the IRS have finalized, with only minor changes, proposed and temporary amendments to the check-the-box regulations under § 7701 (T.D. 9766, Self-Employment Tax Treatment of Partners in a Partnership That Owns a Disregarded Entity, 81 F.R. 26693 (5/4/16).) The amendments clarify 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. Prior to amendment, the check-the-box regulations provided 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 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 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 final amendments 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 and is not the employer of any partner of a partnership that owns the disregarded entity. A partner in a partnership that owns the disregarded entity is subject to the normal self-employment tax rules.

- The IRS's position that a partner cannot be an employee of a disregarded entity owned by the partnership means that compensation to the partner for services rendered to the disregarded entity cannot be reported on Form W-2 and instead must be reported on a Schedule K-1 issued by the partnership. This position also means that such a partner cannot participate in tax-favored employee benefit plans such as cafeteria plans and flexible spending accounts.

- The final regulations apply on the later of (1) August 1, 2016, or (2) the first day of the latest-starting plan year beginning after May 4, 2016, and on or before May 4, 2017, 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 final regulations do not address the application of Rev. Rul. 69-184, 1969-1 C.B. 256 (setting forth the IRS's position that a partner is not an employee of the partnership) to either tiered partnerships or publicly traded partnerships. The preamble to the final regulations indicates that the IRS will continue to consider these issues.

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS