Recent Developments in Federal Income Taxation

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To obtain today's outline and slides:
https://tinyurl.com/outline-may18

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Limit on Deducting Business Interest
2017 TCJA § 13301
Outline: item D.1, page 2

- Amendments to Code § 163(j) limit the deduction of business interest expense – a/k/a "thin cap rules."
- Limit is business interest income plus 30% of "adjusted taxable income" plus floor plan financing
  - ATI generally is earnings before interest, tax, depreciation and amortization (EBITDA) for 2018-2022, then earnings before interest and taxes (EBIT).
- Businesses with average annual gross receipts of $25 million or less (over 3 years) are exempted
- Real estate businesses can elect out, but become subject to alternative depreciation system.

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Notice 2018-28
2018-16 I.R.B. 492
Outline: item D.1.a, page 2

- Provides notice of forthcoming proposed regulations and interim guidance
- Interest disallowed by former § 163(j)
  - Carryforwards
  - Interaction with new "BEAT" provision-§ 59A
- Business interest expense and income of C corporations
- Application of § 163(j) to consolidated groups
- Impact of § 163(j) on C corporation earnings and profits
- Application of § 163(j) to partnerships and S corporations

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CRI-Leslie, LLC v. Commissioner, 882 F.3d 1026 (11th Cir. 2/15/18)

Outline: item A.1.a, page 4

- The taxpayer, an LLC treated as a TEFRA partnership, entered into a contract to sell a hotel property and received a deposit of $9.7 million.
  - The buyer defaulted and forfeited the $9.7 million deposit, which was retained by the taxpayer.
  - The hotel property was a § 1231 asset, not a capital asset.
- Issue:
  - Was the $9.7 million gain long-term capital gain or ordinary income?
- Held: Ordinary income. Section 1234A , relied on by the taxpayer, does not apply to § 1231 property.

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Sugar Land Ranch Dev., LLC v. Commissioner, T.C. Memo. 2018-21 (2/22/18)

Outline: item A.2, page 5

- The taxpayer, an LLC treated as a TEFRA partnership, acquired tracts of land in 1998 just outside Houston.
  - Planned to develop the land into single-family residential building lots and commercial tracts.
  - Performed environmental cleanup, but never subdivided or developed it.
  - When subprime mortgage crisis hit, decided in 2009 not to develop and adopted unanimous resolution stating this.
- In 2011, received unsolicited offer; sold property to developer.
- Issue: Is the taxpayers' gain (or loss) ordinary or capital?
- Held: A capital gain. Taxpayers had ceased to hold the property for sale in the ordinary course of business.

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Simonsen v. Commissioner, 150 T.C. No. 8 (3/14/18)

Outline: item A.3, page 6

- Due to "Great Recession," the taxpayers had converted their underwater principal residence to rental property, but after a year of renting they sold it in a short sale at a big loss compared to their original purchase price. They reported short sale as producing (1) a § 165 loss and (2) excludible COD income under § 108(a)(1)(E). IRS argued no loss, but instead gain due to special rule in Reg. § 1.165-9(b)(2) adjusting basis downward to FMV at time of conversion to rental property.
- Issue: Who's right? Taxpayers or the IRS?
- Held: Neither. Due to unique California law treating home mortgage debt as nonrecourse, and rare no gain/no loss rule of Reg. § 1.165-9(b)(2), the taxpayers and IRS both got it wrong.

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Welch v. Commissioner, T.C. Memo. 2017-229 (11/20/17)

Outline: item C.1, page 7

- Taxpayer, an economics professor, operated a ranch in central Texas that produced losses for 2007-2010 ranging from $2 to $4 million per year.
- Issue: were the losses disallowed by section 183 on the basis that the ranching activity was not engaged in for profit,?
- Held: No. Taxpayer successfully established that the activity was enagegd in for profit.

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Summa Holdings, Inc. v. Commissioner, 848 F.3d 779 (6th Cir. 2/16/17)

Outline: item H.1.a, page 8

- Members of the Benenson family owned C corporation stock.
  - Two family members established Roth IRAs, which (through a holding company) held the shares of a domestic international sales corporation (DISC).
  - The C corporation paid $5.2 million in deductible commissions to the DISC, which excluded them from income. The DISC paid dividends to the Roth IRAs, triggering UBIT.
  - IRS asserted that the structure impermissibly avoided the contribution limits for Roth IRAs, and that the substance-over-form doctrine required recharacterization of the corporation's commission payments as nondeductible dividends.
- Held: IRS cannot use the substance-over-form doctrine to recharacterize the C corporation's commission payments.

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Mazzei v. Commissioner, 150 T.C. No. 7 (3/5/18)

Outline: item H.1.b, page 10

- Members of the Mazzei family owned S corporation stock.
  - Two family members established Roth IRAs, which bought shares in a newly-formed foreign sales corporation (FSC) for $500. [FSCs since repealed.]
  - The S corporation paid over $500k in deductible commissions to the FSC during years 1998 to 2002. Roth IRAs grew and paid no tax on dividends from FSC.
  - IRS asserted that the structure impermissibly avoided the contribution limits for Roth IRAs.
- Held: Roth IRAs not true owners of FSC stock, so IRS position sustained.
- Dissent: Should have followed 6th Circuit in Summa Holdings.

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Proposed Regs. on Section 754 Elections
82 F.R. 47408 (10/12/17)
Outline: item E.1, page 11

- Proposed regulations provide that section 754 elections no longer require a partner's signature
- Taxpayers can rely on the proposed regulations now.

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Rev. Proc. 2018-15
2018-9 IRB 379 (2/8/18)
Outline: item A.3, page 13

- Exempt, nonprofit corporations seeking to reincorporate in another state previously had to re-apply for exempt status (e.g., Form 1023).
  - IRS treated the entity formed in another state as a "new" corporation which must apply for exempt status.
- For-profits, on the other hand, may use § 368(a)(1)(F) ("F Reorg) to reincorporate from state to state.
- Effective 1/1/18, a § 501(c) organization may engage in a "corporate restructuring" (e.g., reincorporation, redomestication, merger, etc.) without having to re-apply for exempt status.
- New corporation is treated as continuation of old, like F Reorg, and keeps same tax identification number.

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Chai v. Commissioner, 851 F.3d 190 (2d Cir. 3/20/17)

Outline: item A.1a, page 15

- The notice of deficiency issued to the taxpayer included a 20 percent accuracy-related penalty.
- Issue: was the IRS barred from asserting the penalty because it had failed to comply with § 6751(b)?
  - Section 6751(b) requires that the "initial determination of … the assessment" of the penalty be "personally approved (in writing) by the immediate supervisor … or such higher level official as the Secretary may designate."
- Held: Yes. The required approval must be given no later than issuance of the notice of deficiency. Disagrees with Tax Court's decision in *Graev v. Commissioner*, 147 T.C. No. 16 (11/30/16).
- Held Further: compliance with § 6751(b) is part of the IRS's burden of production and proof in a deficiency case.
- Recent Decision: *Graev v. Commissioner*, 149 T.C. No. 23 (12/20/17).

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Klein v. Commissioner, 149 T.C. No. 15 (10/3/17)

Outline: item A.2, page 17

- Restitution ordered in a criminal prosecution is not subject to interest and penalties.

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Coffey v. Commissioner, 150 T.C. No. 4 (1/29/17)

Outline: item E.1, page 18

- Taxpayers claimed to be residents of the Virgin Islands and filed their return with the Bureau of Internal Revenue in the Virgin Island.
- Issue: had the limitations period on assessment expired by the time the IRS issued a notice of deficiency?
- Held: Yes. The IRS received information from the BIR in the Virgin Islands, which the court treats as a "return" filed by the taxpayers that started the running of the three-year limitations period.

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Galloway v. Commissioner, 149 T.C. No. 19 (10/17/17)

Outline: item H.1, page 19

- Held: the Code's definition of a deficiency, which makes reference to "the excess of A over B," can be a negative number when B exceeds A.

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