RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

III. INVESTMENT GAIN AND INCOME

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. Ministers pray this "crabby" case gets reversed (again!) on appeal. Gaylor v. Mnuchin, 278 F.Supp.3d 1081 (W.D. Wis. 10/6/17). In a case that previously was overturned on appeal to the Seventh Circuit, the U.S. District Court for the Western District of Wisconsin (Judge Crabb) held that § 107(2) is unconstitutional because it violates the First Amendment's establishment clause. Section 107(2) excludes from gross income a "rental allowance" paid to a minister as part of his or her compensation. Section 107(1) excludes the "rental value of a home" furnished to a minister as part of his or her compensation. For technical reasons, only § 107(2)'s "rental allowance" exclusion was at issue in this case. The named plaintiff, Gaylor, is co-president of the true plaintiff, Freedom from Religion Foundation, Inc. ("FFRF"). In a prior iteration of the case, *Freedom from Religion Foundation, Inc. v. Lew*, 773 F.2d 815 (7th Cir. 2014), the Seventh Circuit vacated Judge Crabb's prior ruling striking down § 107(2) by determining that FFRF lacked standing to sue; however, the Seventh Circuit essentially instructed FFRF on how it might obtain standing. FFRF dutifully followed the Seventh Circuit's directions and then refiled its claim with Judge Crabb that § 107(2) violates the First Amendment's establishment clause. FFRF argued that § 107(2) violates the establishment clause because it "demonstrates a preference for ministers over secular employees." Judge Crabb agreed and ruled that § 107(2) is unconstitutional and ordered the IRS to cease enforcing the statute. In a subsequent decision, though, Judge Crabb ordered that the court's injunction prohibiting enforcement of the statute be stayed until 180 days after resolution of any appeal. *See Gaylor v. Mnuchin*, 2017 U.S. Dist. LEXIS 209746, 2017 WL 6375819 (12/13/17). In other words, stay tuned . . . .

a. Prayers answered! Gaylor v. Mnuchin, ___ F.3rd ___ (7th Cir. 3/15/29), *rev'g* 278 F.Supp.3d 1081 (W.D. Wis. 10/6/17). On appeal, the Seventh Circuit reversed and upheld the constitutionality of § 107(2). Treasury and the IRS argued before the Seventh Circuit that although § 107(2) seems to advance a religious purpose by excluding rental allowances paid to "ministers of the gospel," the history of § 107(2) reveals a secular purpose. To wit, Congress enacted § 107 in 1923 as a response to the IRS's original position in 1921 that the "convenience of the employer" exception for employer-providing housing (now codified at § 119(a)(2)) did not apply to ministers. Treasury and IRS argued that § 107(2) was merely an extension of the "convenience of the employer" exception to gross income, not an impermissible government "establishment" of a religious preference. Writing for the court, Judge Brennan agreed, stating:

> Reading § 107(2) in isolation from the other convenience-of-the-employer provisions, and then highlighting the term "minister," could make the challenged statute appear to provide a government benefit exclusively to the religious. But reading it in context, as we must, we see § 107(2) is simply one of many per se rules that provide a tax exemption to employees with work-related housing requirements.

Moreover, Judge Brennan explained that although § 107(2) has broader application than the "convenience of the employer" exception of § 119(a)(2), the breadth of § 107(2) does not render the statute unconstitutional. In fact, Judge Brennan reasoned that § 107(2) is broadly written to avoid excessive government entanglement with the internal operations of a church. Otherwise, without § 107(2), § 119(a)(2) would require the IRS to interrogate ministers as to the use of their homes for religious purposes. Further, § 119(a)(2) would require the IRS to determine the scope of the "business" of the church and where and how far the "premises" of the church extend. As written, § 107(2) avoids such excessive entanglement of government into the affairs of the church. Similarly, the court determined that § 107(2) does not unconstitutionally "advance" religion over secular purposes because providing a tax exemption does not "connote[] sponsorship, financial support, and active involvement of the [government] in religious activity." Finally, the court ruled that § 107(2) passes the "historical significance" test under the establishment clause because tax exemptions have been provided to religious and religious-affiliated organizations by Congress almost since the Sixteenth Amendment authorized the federal income tax in 1913.

B. Qualified Deferred Compensation Plans

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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

D. Deductions and Credits for Personal Expenses

1. 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. And like Rameses II in The Ten Commandments, Treasury says, "So let it be written; so let it (finally!) be done." REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18). Moving swiftly, Treasury has published proposed regulations under § 170 that purport to close the door on any state-enacted workarounds to new § 164(b)(6). Prop. 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 proposed 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 proposed regulations provide 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. Three examples illustrate the application of the proposed regulation:

- *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 proposed regulation is effective for charitable contributions made after August 27, 2018.

- *On the other hand* . . . . The looming trouble spot here is how taxpayers and the Service discern the difference between abusive "workarounds" enacted in response to new § 164(b)(6) and legitimate state and local tax credit programs such as the Georgia Rural Hospital Tax Credit that preceded TCJA. 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% 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. This follows because the proposed regulations do not condition the reduction in a taxpayer's federal charitable contribution deduction on whether the taxpayer's state and local deduction otherwise would exceed the $10,000 cap of new § 164(b)(6). 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.

c. Speaking of looming trouble spots: The availability of a business expense deduction under § 162 for payments to charities is not affected by the recently issued proposed regulations, 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 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. See REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18). 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."

d. More about trouble spots: The Service must be thinking, "Will this ever end?" Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (12/29/18). Notwithstanding the above guidance, 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.)

e. Like the Energizer Bunny, the issues surrounding the new $10,000 limit on the personal deduction for state and local taxes just keep going . . . and going . . . and going . . . Rev. Rul. 2019-11, ____ I.R.B. ____ (3/29/19). The tax benefit rule has long required taxpayers to include in gross income amounts deducted in a prior tax year that are recovered in the current tax year; however, under § 111(a), the amount so includible in gross income is limited to the amount deducted that resulted in a reduction of the taxpayer's tax liability for the prior year. In other words, the inclusion in gross income of the amount recovered is limited to the "tax benefit" of the amount previously deducted. *See* Rev. Rul. 93-75, 1993-2 C.B. 63 (inclusion not required for that portion of a taxpayer's state and local tax refund for which a deduction previously was disallowed under the fomer 3 percent/80 percent limitation on itemized deductions of § 68(a)). Likewise, if a taxpayer's deduction for personal state and local taxes was limited to $10,000 for a prior year (e.g., 2018) by new § 164(b)(6), then a portion of the taxpayer's personal state and local tax refund received in the current year (e.g., 2019) should be excludable from gross income for the current year under § 111. The question, of course, is determining exactly how much of a taxpayer's personal state and local tax refund is excludable for the current year under § 111, especially where the $12,000 standard deduction might have been used by the taxpayer had he or she paid the proper amount of personal state and local taxes due for the prior year instead of making an overpayment. Rev. Rul. 2019-11 holds that the proper amount includible in gross income in these circumstances under § 111 is the *lesser of* (1) the difference between the taxpayer's total itemized deductions taken in the prior year and the amount of itemized deductions the taxpayer would have taken in the prior year had the taxpayer paid the proper amount of state and local tax, or (2) the difference between the taxpayer's itemized deductions taken in the prior year and the standard deduction amount for the prior year, if the taxpayer was not precluded from taking the standard deduction in the prior year. The above holding applies to the recovery of any state or local tax, including state or local income tax and state or local real or personal property tax. To assist taxpayers in determining the proper amount excludible from gross income under § 111 with respect to a refund of personal state and local taxes subject to the § 164(b)(6) $10,000 limit for a prior year, Rev. Rul. 2019-11 provides several helpful examples. In each example, it is assumed that the taxpayers are unmarried individuals whose filing status is "single" and who itemized deductions on their federal income tax returns for 2018 in lieu of using their standard deduction of $12,000. It is further assumed that the taxpayers did not pay or accrue the taxes in carrying on a trade or business or an activity described in § 212. Moreover, it is assumed that for 2018 the taxpayers were not subject to alternative minimum tax under § 55 and were not entitled to any credit against income tax. Finally, it is assumed that the taxpayers use the cash receipts and disbursements method of accounting.

- *Situation 1 (State income tax refund fully includable).*

  Facts: Taxpayer A paid local real property taxes of $4,000 and state income taxes of $5,000 in 2018. A's state and local tax deduction was not limited by section 164(b)(6) because it was below $10,000. Including other allowable itemized deductions, A claimed a total of $14,000 in itemized deductions on A's 2018 federal income tax return. In 2019, A received a $1,500 state income tax refund due to A's overpayment of state income taxes in 2018.

  Held: In 2019, A received a $1,500 refund of state income taxes paid in 2018. Had A paid only the proper amount of state income tax in 2018, A's state and local tax deduction would have been reduced from $9,000 to $7,500 and as a result, A's itemized deductions would have been reduced from $14,000 to $12,500, a difference of $1,500. A received a tax benefit from the overpayment of $1,500 in state income tax in 2018. Thus, A is required to include the entire $1,500 state income tax refund in A's gross income in 2019.

- *Situation 2 (State income tax refund not includable)*

  Facts: Taxpayer B paid local real property taxes of $5,000 and state income taxes of $7,000 in 2018. Section 164(b)(6) limited B's state and local tax deduction on B's 2018 federal income tax return to $10,000, so B could not deduct $2,000 of the $12,000 state and local taxes paid. Including other allowable itemized deductions, B claimed a total of $15,000 in itemized deductions on B's 2018 federal income tax return. In 2019, B received a $750 state income tax refund due to B's overpayment of state income taxes in 2018.

  Held: In 2019, B received a $750 refund of state income taxes paid in 2018. Had B paid only the proper amount of state income tax in 2018, B's state and local tax deduction would have remained the same ($10,000) and B's itemized deductions would have remained the same ($15,000). B received no tax benefit from the overpayment of $750 in state income tax in 2018. Thus, B is not required to include the $750 state income tax refund in B's gross income in 2019.

- *Situation 3 (State income tax refund partially includable)*

  Facts: Taxpayer C paid local real property taxes of $5,000 and state income taxes of $6,000 in 2018. Section 164(b)(6) limited C's state and local tax deduction on C's 2018 federal income tax return to $10,000, so C could not deduct $1,000 of the $11,000 state and local taxes paid. Including other allowable itemized deductions, C claimed a total of $15,000 in itemized deductions on C's 2018 federal income tax return. In 2019, C received a $1,500 state income tax refund due to C's overpayment of state income taxes in 2018.

  Held: In 2019, C received a $1,500 refund of state income taxes paid in 2018. Had C paid only the proper amount of state income tax in 2018, C's state and local tax deduction would have been reduced from $10,000 to $9,500 and as a result, C's itemized deductions would have been reduced from $15,000 to $14,500, a difference of $500. C received a tax benefit from $500 of the overpayment of state income tax in 2018. Thus, C is required to include $500 of C's state income tax refund in C's gross income in 2019.

- *Situation 4 (Standard deduction)*

  Facts: Taxpayer D paid local real property taxes of $4,250 and state income taxes of $6,000 in 2018. Section 164(b)(6) limited D's state and local tax deduction on D's 2018 federal income tax return to $10,000, so D could not deduct $250 of the $10,250 state and local taxes paid. Including other allowable itemized deductions, D claimed a total of $12,500 in itemized deductions on D's 2018 federal income tax return. In 2019, D received a $1,000 state income tax refund due to D's overpayment of state income taxes in 2018.

Held: In 2019, D received a $1,000 refund of state income taxes paid in 2018. Had D paid only the proper amount of state income tax in 2018, D's state and local tax deduction would have been reduced from $10,000 to $9,250, and, as a result, D's itemized deductions would have been reduced from $12,500 to $11,750, which is less than the standard deduction of $12,000 that D would have taken in 2018. The difference between D's claimed itemized deductions ($12,500) and the standard deduction D could have taken ($12,000) is $500. D received a tax benefit from $500 of the overpayment of state income tax in 2018. Thus, D is required to include $500 of D's state income tax refund in D's gross income in 2019.

2. In determining eligibility for the § 36B premium tax credit, a taxpayer's modified adjusted gross income includes lump-sum Social Security benefits attributable to a prior year, even if the taxpayer has made an election under § 86(e). Johnson v. Commissioner, 152 T.C. No. 6 (3/11/19). Section 86(e) permits a taxpayer who receives a lump-sum Social Security payment that is attributable to a prior year to limit the portion that is taxed by electing to include in gross income only the portion of the payment equal to the increase in gross income that would have occurred had the taxpayer taken the payment into account in the prior year to which the payment is attributable. For example, assume that (1) a taxpayer receives a $100 lump-sum Social Security payment this year that is attributable to last year, (2) $60 of the payment would be included in gross income this year, and (3) if the taxpayer had taken the payment into account last year, only $40 would have been included in gross income. The taxpayer in this example could elect under § 86(e) to include in gross income this year only $40 of the payment. The issue in this case is the effect of a § 86(e) election on the calculation of a taxpayer's modified adjusted gross income (MAGI) for purposes of determining eligibility for the premium tax credit authorized by § 36B for individuals who meet certain eligibility requirements and purchase health insurance coverage under a qualified health plan through an Affordable Insurance Exchange. 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 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 increased by certain items, including:

> an amount equal to the portion of the taxpayer's social security benefits (as defined in section 86(d)) which is not included in gross income under section 86 for the taxable year.

The taxpayer in this case received total Social Security benefits in 2014 of $26,180, of which $11,092 was attributable to a lump-sum payment relating to 2013. By making a § 86(e) election, the taxpayer limited the taxable portion of the total benefits received in 2014 to $6,687. The taxpayer argued that his MAGI for 2014 as defined in § 36B(d)(2)(B) should include none of the $11,092 of Social Security benefits attributable to 2013 or, at most, should include only the portion of his 2013 benefits included in his gross income for 2014. The taxpayer focused on the statutory phrase "under section 86 for the taxable year" in § 36B(d)(2)(B) and argued that the statute required inclusion in MAGI for 2014 only benefits attributable to *the taxable year* (2014) for which the determination was being made, and not those attributable to 2013. The Tax Court (Judge Gerber) held that the taxpayer's § 86(e) election had no effect on the determination of the taxpayer's MAGI for 2014. According to the court:

> We hold that the text of the statute is not ambiguous and that petitioner must include in his MAGI all of the Social Security benefits received in 2014, irrespective of the section 86(e) election. As a result, petitioner's adjusted gross income is increased by the amount of Social Secrutiy benefits not included in gross income and, as explained below, his MAGI excereds the established threshold for PTC leigibility by a relatively small amount.

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

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, Notice 2019-20 provides limited relief. Specifically, the IRS will waive penalties (i) 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, (ii) under § 6038 for failure to furnish a Schedule K-1 (Form 8865), and (iii) 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 Employee 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.

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Accuracy-related penalties determined by the IRS's Automated Correspondence Exam system are penalties "automatically calculated through electronic means" and therefore are not subject to the requirement of § 6751(b) that they be approved in writing by a supervisor. Walquist v. Commissioner, 152 T.C. No. 3 (2/25/19). The 2014 federal income tax return filed by the taxpayers, a married couple, reflected wages and other income of $94,114 and a purported offset or deduction of $87,648, labeled as a "Remand for Lawful Money Reduction." They failed to report $1,215 of unemployment compensation reported on Form 1099-G by the State of Minnesota. After taking into account the standard deduction, the taxpayers reported negative taxable income of ($5,731). The IRS's computer document matching system identified the return for examination, which was processed by the IRS's Automated Correspondence Exam (ACE) system. The ACE system employed the IRS's Correspondence Examination Automated Support (CEAS) software, which generated and issued to the taxpayers a Letter 525, General 30-Day Letter. The 30-day letter calculated a proposed deficiency $13,832 and automatically calculated a 20 percent ($2,766.40) accuracy-related penalty pursuant to § 6662(a), (b)(2), and (d)(1)(A) for a substantial understatement of income tax. Following the taxpayers' failure to respond to the 30-day letter, the CEAS program generated a notice of deficiency, in response to which the taxpayers filed what purported to be a petition in the Tax Court. They filed a copy of the notice of deficiency, on each page of which they had written "REFUSAL FOR CAUSE," and attached various documents that set forth arguments commonly made by tax protestors as well as a demand that the Tax Court garnish the wages of the Secretary of the Treasury. Among other issues in the case, the Tax Court (Judge Lauber) addressed whether the accuracy-related penalty calculated by the IRS's CEAS program was subject to the requirement of § 6751(b) that the initial determination of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The court held that it was not. In *Graev v. Commissioner*, 149 T.C. No. 23 (2017), the Tax Court held that compliance with § 6751(b)(1) is properly a part of the IRS's burden of production under I.R.C. § 7491(c). Further, in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), the U.S. Court of Appeals for the Second Circuit held that "the written approval requirement of § 6751(b)(1) is appropriately viewed as an element of a penalty claim, and therefore part of the IRS's *prima facie* case." Section 6751(b)(2), however, provides that supervisory approval is not required for "any addition to tax under section 6651, 6654, or 6655, or" for "any other penalty automatically calculated through electronic means." The penalty in this case, the court concluded, "was determined automatically by a computer software program without the involvement of a human IRS examiner," and therefore was a penalty "automatically calculated through electronic means" within the meaning of § 6751(b)(2)(B). The court noted that its decision is consistent with the IRS's Internal Revenue Manual, which states that substantial understatement penalties determined by the CEAS program (as well as those calculated through the Automated Underreporter program) are exempt from the supervisory approval requirement. The court also noted that its conclusion is consistent with the policy underlying the supervisory approval requirement of § 6751(b), which was enacted as a means of preventing IRS employees from threatening unjustified penalties to encourage settlement. Because the supervisory approval requirement did not apply, the IRS had no burden of production with respect to the penalty. The court also imposed a penalty of $12,500 on the taxpayers pursuant to § 6673(a)(1) for advancing frivolous positions in their petition and in subsequent proceedings.

- The Tax Court previously had held in Williams v. Commissioner, 151 T.C. No. 1 (7/3/18), that the supervisory approval requirement of § 6751(b) does not apply to the Tax Court when it imposes penalties under § 6673(a)(1).

2. The supervisory approval requirement of § 6751(b) "includes no requirement that all potential penalties be initially determined by the same individual nor at the same time," says the Tax Court. Palmolive Building Investors, LLC v. Commissioner, 152 T.C. No. 4 (2/28/19). The taxpayer, a TEFRA partnership, granted in 2004 a conservation easement valued at $257 million on the façade of the Palmolive Building on North Michigan Avenue in Chicago. In a prior opinion, the Tax Court upheld the IRS's disallowance of the taxpayer's charitable contribution deduction on the ground that mortgages on the building were not fully subordinated to the conservation easement and therefore the charitable organization in whose favor the easement was granted was not, as required by relevant regulations, guaranteed the requisite share of proceeds in the event the easement was extinguished. *See Palmolive Building Investors LLC et al. v. Commissioner*, 149 T.C. No. 18

(10/13/17). The remaining issue was whether, in asserting certain penalties, the IRS had complied with the requirement of § 6751(b) that the initial determination of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." During the examination of the partnership return for the year in question, the IRS's examining agent prepared Form 5701 (Notice of Proposed Adjustment) that had two Forms 886A (Explanation of Items) attached to it. One of the Forms 886A proposed and justified a penalty for gross valuation misstatement under § 6662(h)(1) and the other proposed and justified, in the alternative, a 20 percent negligence penalty under § 6662(b)(1). The agent's supervisor signed the Form 5701. The IRS issued a 30-day letter (Letter 1807) inviting the taxpayer to a closing conference to discuss the adjustments. The 30-day letter referenced only the gross valuation misstatement penalty. Subsequently, the IRS issued a 60-day letter (Letter 1827) proposing adjustments and giving the taxpayer 60 days within which to file a protest with IRS Appeals. The 60-day letter had attached to it the Form 5701 and both Forms 886-A, i.e., it referenced both penalties. In IRS Appeals, the Appeals Officer assigned to the case prepared a Form 5402-c (Appeals Transmittal and Case Memo) that had attached to it a proposed Notice of Final Partnership Administrative Adjustment, (FPAA) the last page of which was a Form 886A that asserted both the original penalties and, in the alternative, two additional penalties: a 20 percent penalty for substantial understatement of income tax under § 6662(b)(2) and a 20 percent penalty for substantial valuation misstatement under § 6662(b)(3). The immediate supervisor of the Appeals Officer signed both the Form 5402-c and the proposed FPAA. The Tax Court (Judge Gustafson) held that the IRS had complied with the supervisory approval requirement of § 6751(b). In reaching this conclusion, the court rejected the taxpayer's argument that the requirement had not been met with respect to the additional two penalties asserted by the Appeals Officer. "Section 6751(b)(1) includes no requirement that all potential penalties be initially determined by the same individual nor at the same time." The court also rejected the taxpayer's argument that the supervisory approval requirement had not been met because the IRS had failed to comply with certain provisions of the Internal Revenue Manual regarding documentation of penalty approval in workpapers. The court emphasized that § 6751(b)(1) "does not require written supervisory approval on any particular form" and does not require the signature or written name of the person making the initial determination of the penalty. The taxpayer also argued that the supervisory approval requirement had not been met because the IRS had failed to establish when the initial determinations of the penalties had been made and because the initial 30-day letter received by the taxpayer referred only to the gross valuation misstatement penalty and not to the negligence penalty. The court rejected these arguments as well. The court reasoned that the examining agent and the Appeals Officer each made their initial determinations at the time they solicited their respective supervisors' approval, and their supervisors had given the requested approval in writing.

3. Don't think you can escape the penalty for filing an S corporation return late, even if you are the only shareholder, by requesting an extension of time to file your individual federal income tax return. ATL & Sons Holdings, Inc. v. Commissioner, 152 T.C. No. 8 (3/13/19). The petitioner in this case was a subchapter S corporation that filed its 2012 return on Form 1120S late. The S corporation failed to request an extension of time to file its return by filing Form 7004. The sole shareholders of the S corporation were Ralph and Cassandra Allen, a married couple, who timely requested an extension of time to file their 2012 federal income tax return and who timely filed the return by the extended due date. The IRS assessed a $2,340 penalty against the S corporation pursuant to § 6699 for the late filing of its return. The assessment appeared on the S corporation's account transcript with transaction code 166, which indicated that it was a computer-generated assessment of a delinquency penalty. The S corporation had made an unspecified overpayment for 2013, which the IRS credited against the 2012 penalty. The IRS issued a final notice of intent to levy for the balance of the 2012 penalty, in response to which the S corporation requested a collection due process hearing. Following the CDP hearing, which the Allens missed but for which they submitted some additional information, the IRS settlement officer upheld the proposed collection action and the S corporation brought this challenge in the Tax Court. The Tax Court (Judge Gustafson) held that the settlement officer had not abused her discretion in upholding the proposed collection action and granted the IRS's motion for summary judgment. The court noted than an S corporation is an entity separate from its shareholders and is required to file its own return and to request its own extension of time to file the return. The court rejected the S corporation's argument that the penalty should be abated because the IRS had agreed to excuse the penalty under similar circumstances in a different year. The court also disagreed with the S corporation's position that it had a good faith, reasonable cause defense to the penalty because it had only two shareholders who were aware of the S corporation's loss for the year and that no harm had resulted from the late filing. "Section 6999 does not include a condition of harm before the penalty is imposed; it simply imposes a penalty when the filing is late (without reasonable cause)." The court also held that the late-filing penalty of § 6699 was not subject to the requirement of § 6751(b) that the initial determination of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." Section 6751(b)(2) provides that supervisory approval is not required for "any addition to tax under section 6651, 6654, or 6655, or" for "any other penalty automatically calculated through electronic means." The court held that the § 6699 penalty is a "penalty automatically calculated through electronic means" and therefore is not subject to the § 6751(b) supervisory approval requirement. The court rejected the taxpayers' argument that, because the penalty in question is subject to a good faith, reasonable cause defense, it is not a penalty that is "automatically calculated." "The possibility of such a defense does not change the fact that the penalty itself is 'automatically calculated.'" Regarding the IRS's crediting of the S corporation's 2013 overpayment against the 2012 § 6699 penalty, the court held that the IRS's action had not violated § 6330(e)(1), which prohibits a levy before the conclusion of a CDP hearing. Although that provision prohibits collection by levy, "[n]othing in section 6330 prohibits the IRS from engaging in other nonlevy collection actions, including offsetting payments from other periods, as the IRS did in this instance."

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

1. ♪♫If you want my love, leave your name and address …♫♪ A notice of deficiency mailed to the address on the taxpayers' tax return was mailed to the taxpayers' last known address despite their filing of a power of attorney and a request for an extension using their new address. Gregory v. Commissioner, 152 T.C. No. 7 (3/13/19). Section 6212(b)(1) provides that a notice of deficiency in respect of a tax imposed by subtitle A shall be sufficient if "mailed to the taxpayer at his last known address." For this purpose, a taxpayer's last known address is "the address that appears on the taxpayer's most recently filed and properly processed Federal tax return, unless the Internal Revenue Service (IRS) is given clear and concise notification of a different address". Reg. § 301.6212-2(a). The taxpayers in this case, a married couple, moved from Jersey City, New Jersey to Rutherford, New Jersey, on June 30, 2015. They filed their 2014 federal income tax return on October 15, 2015. The return incorrectly reflected their old, Jersey City address. In November 2015, a power of attorney on Form 2848 was submitted to the IRS that had their new, Rutherford address. In April 2016, they filed a request for an automatic extension of time to file their 2015 federal income tax return on Form 4868 that also had their new, Rutherford address. The IRS sent a notice of deficiency with respect to tax year 2014 by certified mail to the taxpayers' old, Jersey City address on October 13, 2016. The U.S. Postal Service returned the notice of deficiency to the IRS as unclaimed; the taxpayers never received it. They first became aware of the notice of deficiency on January 17, 2017, and, in response, filed a petition in the Tax Court that same day. The IRS moved to dismiss for lack of jurisdiction because the taxpayers had filed their petition late (outside the 90-day time period of § 6213(a)), and the taxpayers moved to dismiss for lack of jurisdiction on the ground that the petition had not been mailed to their last known address and therefore was invalid. The Tax Court (Judge Buch) held that the notice of deficiency had been mailed to the taxpayers' last known address and granted the government's motion to dismiss. The court first reasoned that neither the Form 2848 nor the Form 4868 submitted by the taxpayers was a "return" within the meaning of the last known address rule of Reg. § 301.6212-2(a). These forms, the court reasoned, are not returns under the four-part test of *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986). Further, the court explained, Reg. § 301.6212-2(a) provides that additional information on what constitutes a return for purposes of the last known address rule can be found in procedures published by the IRS, and Rev. Proc. 2010-16, 2010-19 I.R.B. 664, specifically provides that Forms 2848 and 4868 are not returns for this purpose. The court next concluded that the Forms 2848 and 4868 submitted by the taxpayers had not provided the IRS with clear and concise notification of their new address. The instructions to both forms, the court reasoned, explicitly provide that the forms will not update a taxpayer's address of record with the IRS. That these forms do not constitute clear and concise notification of a new address, the court explained, is implicit in Rev. Proc. 2010-16, which provides that Forms 2848 and 4868 are not returns and that they "will not be used by the Service to update the taxpayer's address of record." Finally, the court distinguished earlier decisions holding that a Form 2848 filed with the IRS does give clear and concise notification of a new address. *See Hunter v. Commissioner*, T.C. Memo. 2004-81; *Expanding Envelope & Folder Corp. v. Shotz*, 385 F.2d 402 (3d Cir. 1997). The court reasoned that these decisions were based on prior versions of Form 2848 and that "[s]ince 2004 the Commissioner has issued clear guidance informing taxpayers of what actions will and will not change their last known address with the Commissioner."

- If the taxpayers appeal this decision, the appeal will be heard by the U.S. Court of Appeals for the Third Circuit, the same court that held in *Expanding Envelope & Folder Corp.* that a prior version of Form 2848 did provide clear and concise notification of a taxpayer's new address. Stay tuned.

E. <u>Statute of Limitations</u>

F. <u>Liens and Collections</u>

1. ♪♫You say $19.5 million, I say $12,603. Let's call the whole thing off.♫♪ We don't see many taxpayer victories in the Tax Court following a collection due process hearing, but this case is one of them. [Campbell v. Commissioner](), T.C. Memo. 2019-4 (2/4/19). In response to a notice of federal tax lien and a final notice of intent to levy with respect to $1.2 million of unpaid tax liability and an accuracy-related penalty for 2001, the taxpayer requested a collection due process hearing. Following the CDP hearing, the IRS issued a notice of determination upholding the proposed collection action. The taxpayer sought review of the notice of determination by filing a petition in the Tax Court. In response to motions for summary judgment by the IRS, the Tax Court twice remanded the case to the IRS Appeals Office for supplemental CDP hearings. In the first supplemental CDP hearing, the taxpayer submitted an offer-in-compromise offering to compromise all liabilities for $12,603. The IRS calculated the taxpayer's reasonable collection potential (RCP) as $1.5 million and issued a notice of determination rejecting the proposed offer-in-compromise. The taxpayer asserted that, in the first supplemental CDP hearing, the IRS had failed to address state law issues that could affect nominee and alter ego theories. In the second supplemental CDP hearing, the Appeals Officer increased the taxpayer's RCP to $19.5 million and issued a second supplemental notice of determination rejecting the taxpayer's offer-n-compromise and sustaining the proposed collection action. The Tax Court (Judge Kerrigan) held that the IRS Appeals Officer abused her discretion in upholding the proposed collection action and declined to sustain the notice of determination. Specifically, the court held that the Appeals Officer abused her discretion in determining the taxpayer's RCP in three respects. **First,** according to the Internal Revenue Manual, dissipated assets can be taken into account in determining a taxpayer's RCP if the transfer of assets took place within a three-year period immediately preceding the taxpayer's submission of an offer-in-compromise. (Generally, dissipated assets are those disposed of in an attempt to avoid payment of a tax liability, or disposed of after the tax is assessed for items other than the production of income or for the health and welfare of the taxpayer and family members.) Assets transferred outside the three-year look-back period can be taken into account if they were transferred within six months before or after the tax was assessed. The taxpayer had submitted the offer-in-compromise in March 2014. The tax had been assessed on April 19, 2010, which meant that the Appeals Officer could look back to assets transferred within six months of that date. The Appeals Officer, however, took into account $5 million that the taxpayer had contributed in 2004 to an irrevocable grantor trust established in the West Indies. The court found that, even after making this contribution, the taxpayer's net worth exceeded any potential tax liability and that the Appeals Officer had abused her discretion in treating trust assets as dissipated assets. The court also found that the Appeals Officer abused her discretion by treating as dissipated assets investments the taxpayer had made in residential and commercial real estate on the Gulf Coast region under Go Zone legislation from 2006 through 2010 that were lost due to issues such as Chinese drywall in some of the homes and the 2008 subprime mortgage crisis. "There is no indication in the record, and none was demonstrated at trial, that petitioner invested in the Go Zone in an attempt to avoid paying his 2001 tax liability." **Second,** the Appeals Officer determined that the West Indies trust was a nominee or alter ego of the taxpayer, and therefore the trust's assets could be taken into account in determining

RCP as amounts collectible from third parties. According to *Drye v. United States*, 528 U.S. 49 (1999), this conclusion requires an inquiry whether the taxpayer has rights in property under state law and, if so, whether the taxpayer's rights qualify as property rights under federal tax law. The taxpayer, as beneficiary of the trust and with limited rights to request distributions or to request replacement of the trustee, argued that he had no property interest in the trust's assets. The court found that the Appeals Officer had abused her discretion in determining that the trust was the taxpayer's nominee or alter ego because the IRS had produced no evidence that petitioner had a property right in the trust under state law. **Third,** the court held that the Appeals Officer had abused her discretion in determining that the taxpayer had control over the trust's assets and that the assets therefore could be taken into account in determining RCP as assets available to the taxpayer but beyond the reach of the government. The court found that the taxpayer did not have control over the trustee and specifically did not control the trustee's decision to invest in some of the Gulf Coast real estate projects of the taxpayer.

G. Innocent Spouse

H. Miscellaneous

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS