FEDERAL TAX UPDATE

WEST VIRGINIA TAX INSTITUTE

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I. Tax Cuts and Jobs Act of 2017 – Pub L. 115-97 (TCJA)

1. Corporate AMT Repealed:	AMT credit carryover that would have been usable is refundable annually with limits.
2. Corporate Tax Rates:	21% flat rate on all income. Same for PSC's.
3. Dividends Received Deduction:	65% and 50% instead of 80% and 70%.
4. Cash Method of Accounting:	Permitted for businesses with under $25 million gross sales indexed.
5. Inventories:	If gross receipts are under $25 million, Taxpayer can either conform to financial statements or treat as non-incidental materials and supplies and do not need to use UNICAP rules.
6. Completed Contract Method:	If a contract is to be completed within 2 years and you are under $25 million gross receipts, you can use completed contract.
7. Accrual Basis Revenue Recognition:	Cannot defer recognition of income if recognized for financial statements. Rev. Proc. 2004-34 deferral method of recognition of advanced payments is codified. §481 adjustment to change accounting methods gets a 6 year spread for this method.
8. Contributions to Capital by Governmental Agencies:	§118 and Cuba Railway modified and clarified. Clarifies that it applies only to corporations and makes some "contributions" taxable.
9. Depreciation and Immediate Expensing:	Until 2023, certain qualified property gets 100% write-off with no limit on amount. Percentages decrease after 2023. Taxpayer can elect 50% write-off in lieu of 100%.
10. Luxury Auto Depreciation Limits Increased & Indexed:	Over 5 years, depreciation limit before indexing is increased to $41,360.
11. Computers and Peripheral Equipment:	No longer treated as listed property. No longer need contemporaneous logs.
12. Business Interest Expense Deduction:	Larger businesses can deduct only up to the sum of interest income plus 30% of adjusted taxable income (taxable income plus §199 Domestic Production Deduction plus §199A flow-through deduction). If gross receipts are under

	$15 million, you are exempt. Carryover disallowed expense indefinitely.
13. Domestic Production Activities Deduction:	§ 199 repealed except for C corporations. Repealed for C corporations after 2018.
14. § 179 Expensing:	In 2018, you can expense up to $1 million. This includes roofs, heating, ventilation, air conditioning, fire alarm, security systems for non-residential property. Phase out if $2.5 million or more of property placed in service.
15. NOL's:	No more carrybacks except farming and casualty and property insurance companies. Carry-forward indefinitely. NOL carry-forward limited to 80% of taxable income.
16. Like-Kind Exchanges of Real Estate:	No longer applicable to real estate held primarily for sale.
17. Meals and Entertainment:	50% Deduction retained. Repeals deductions for employer paid entertainment, amusement, recreation, social clubs and facilities associated with Taxpayer's business, and, after 2025, for meals provided at convenience of employer.
18. Intellectual Property:	Self-created patents, inventions, models, designs, secret formula or process NOT a capital asset. Taxpayer can elect to treat musical composition or copyright as a capital asset. Rule treating the transfer of a patent before its commercial exploitation as long-term capital gain is repealed.
19. Research and Experimentation Expenses:	After 2021, if conducted outside the United States, must capitalize and amortize over 15 years, and if disposed of, must continue to amortize over the remaining life.
20. Rehabilitation Credit:	Changed to 20% of qualified rehabilitation expenditures and must be claimed ratably over 5 years.
21. Tax-Exempt Bonds:	Bonds issued to prepay another bond will not be tax-exempt. New tax credit bonds may not be issued after 2017.
22. Life Insurance Contracts:	New reporting requirements when an existing contract is purchased and when death benefits are paid on such a purchased policy. Transfer for value rules also changed in reportable sale transactions. Rules for determining basis of a policy or annuity are now codified.
23. Deductibility of Settlements	Deduction for cost of settlement and attorneys' fees and other costs are denied in sexual harassment or sexual abuse

and Attorneys' Fees: cases if subject to a non-disclosure agreement.

24. Family and Medical Leave Tax Credit: Employers who pay at least 50% of pay to employees for family and medical leave get a 12.5% tax credit based on wages paid during leave, this percentage goes up to 25% of pay as pay for leave exceeds 50% of usual pay.

25. No Deduction for Violation of Law Payments Where Governmental Agency is Complainant: Deduction denied for payments for violation of a law or investigation of a violation of law if a governmental agency is the complainant or investigator. A few exceptions are provided.

26. Tax Deduction for Income of Pass-Through Entities: (a) Applies to income of S corporations, partnership and proprietorship income.

(b) Measure income at the owner level.

(c) Deduction is 20% of net qualified business income subject to phase-out. If net taxable income exceeds $315,000 if married filing joint or $157,500 for other filers, the deduction phases out to zero at $415,000 or $207,500, respectively. If you are a professional (law, accounting, medicine, financial advice and others), the phase-out cannot be clawed back. If in any other business, the deduction is the lesser of the 20% of the amount or the greater of 50% of allocable wages paid or 25% of allocable wages paid plus 2.5% of the unadjusted basis of qualified property used in the trade or business undepreciated for 10 years after acquisition.

(d) Deduction applies to operating income only, not investment income.

(e) Deduction is below the line, not subject to phase-out and available to itemizers and non-itemizers.

(f) Deduction is available to trusts and estates and is allocated between beneficiaries and the trust or estate.

(g) Deduction is available even if you are passive.

(h) If all flow-throughs owned by a Taxpayer aggregate to a loss, the loss carries over to offset income subject to the 20% deduction in later years.

27. S Election Revocations: For an S corporation that revokes its S election in the 2 years after the date of enactment, distributions to owners come out of AAA if owners are the same. Expands post

	termination transition period by a year.
28. Permissible Beneficiaries of ESBTs:	Non-resident aliens are now permissible beneficiaries of ESBTs.
29. ESBT Charitable Contributions:	ESBT charitable contributions are now treated as made by S corporation portion of the Trust using the same rules for percentage limits and carryovers as for individuals.
30. Partnership Property Basis:	Partnership property basis must be adjusted downward on a transfer of a partnership interest if the basis adjustment downward is at least $250,000.
31. Charitable Contribution Deduction and Foreign Taxes deduction now subject to limitation	Charitable contribution deduction and foreign taxes deduction now subject to limitation based on basis in partnership interest but this does not apply to the excess of fair market value of appreciated property donated over its adjusted basis.
32. Sale of Partnership Interest:	Sale of a partnership interest where the partnership is engaged in a United States trade or business is treated as generating gain effectively connected to a United States trade or business.
33. Sale or Exchange of Capital or Profits in a Partnership:	The sale or exchange of more than 50% of the capital or profits interest in a partnership no longer terminates the partnership.
34. Partnership Carried Interests:	Carried interests in partnerships now have a 3 year holding period requirement for long-term capital gain treatment.
35. Bicycle Commuting Reimbursements:	Qualified bicycle commuting reimbursements are now taxable.
36. Roth IRA Conversions:	You are no longer permitted to unwind a Roth conversion by re-characterizing a conversion.
37. Employee Termination of Employment With a Plan Loan:	An employee who severs employment or whose qualified plan terminates and has a plan loan outstanding now has one year to contribute the loan balance to an IRA tax free (increased from 60 days).
38. $1 Million Limit on Compensation Deductibility:	Generally, for public companies, the $1 million limit on compensation to be deductible now applies only to CEO, CFO and 3 highest paid employees even if they later fall out of that classification. No exceptions any more for performance based compensation or commissions.

39. Additional Deferral Options for Employees with Stock Options or Restricted Stock Units:	Employees granted restricted stock units or stock options are now allowed additional deferral options if some complex rules are met.
40. Tax Rates Change:	Standard deduction goes to $24,000 for joint, $18,000 for head of household, $12,000 for single, indexed beginning after 2018. The personal exemptions deduction is eliminated.
41. AMT Exemptions Increase:	Alternative minimum tax exemptions increase to $109,400 married filing joint; $70,300 single, $54,700 married filing separate. AMT exemptions phase out at $1 million of income for married filing joint; $500,000 for others. All amounts indexed after 2018.
42. Misc. Itemized Deductions:	Miscellaneous itemized deductions are no longer deductible. Teacher expenses deductible above the line are increased to $500. No more phase-out of itemized deductions at high income levels.
43. Mortgage Interest Deduction:	Mortgage interest is deductible up to $750,000 of acquisition indebtedness. Older debt is grandfathered. New rule not limited to principal residence. No more deduction for HELOC loan interest.
44. State and Local Income Tax Deductibility:	State and local income taxes in carrying on a trade or business are deductible by the business. Other state and local taxes and foreign taxes are subject to limitation. Taxpayer can elect to deduct property, state, local and foreign income taxes up to $10,000, $5,000 for married filing separate.
45. Congressmen Living Expenses:	Away from home living expenses of Congressman up to $3,000 per year no longer deductible.
46. Charitable Contributions:	Charitable contribution 50% AGI limit increased to 60%. 80% deduction for contributions made for university athletic seating rights repealed. No longer need written acknowledgement from charity for donations over $250 if donee organization files the required return.
47. Personal Casualty Loss Deduction:	The personal casualty loss itemized deduction is now limited to federally declared disasters.
48. Expenses in Generation of Wagering Income:	Expenses incurred in generating wagering income, like travel to the casino, are now allowed, but, as usual, limited

	to wagering income.
49. Medical Expenses:	Medical expenses are deductible if over 7.5% of AGI (down from 10%) and no longer generate an AMT preference.
50. Alimony:	Alimony is no longer income to the recipient or deductible by the payer.
51. Moving Expense Deduction:	The moving expense deduction is eliminated except for members for armed forces and reimbursements are now income to employee.
52. Child Tax Credit:	The child tax credit is increased to $2,000, $1,400 of which is refundable. Phases out beginning at $400,000 of income. Non-child dependents qualify for $500 credit.
53. Employee Achievement Awards:	Employee achievement awards to be tax-exempt cannot be cash, cash equivalents, gift coupons or certificates, vacations, meals, lodging, tickets to theaters or sporting events, and similar items.
54. Estate Tax, Gift Tax and GST Tax Exemptions:	The exemption from estate, gift and generation-skipping transfer taxes is raised to double the current exemption. $11.180 million in 2018 and will be indexed.

II. Promoter Penalties Appeal and Review - *Larson v. US* (2nd Cir., April 25, 2018)

A promoter of the "KPMG Tax Shelters" was penalized for failure to furnish information regarding reportable transactions under IRC § 6707. This is an assessable penalty which means that it may be assessed without first allowing pre-payment review in Tax Court through notice of deficiency. In these cases, taxpayer must pay the penalty and sue for refund, generally in US District Court or in US Court of Claims. Some penalties are divisible so taxpayer need only pay the penalty with regard to one incident in order to get court jurisdiction. The promoter penalty in this case was determined to NOT be divisible and so promoter must pay the entire penalty in order to get it reviewed. In this case, the total penalty was $160.2 million. Taxpayer's portion was $63.4 million. Taxpayer could not pay and claimed this essentially precluded him from contesting the penalty. Various constitutional and procedural arguments were rejected by the court.

III. Equitable Recoupment Doctrine Applies to Employment Tax Deposit

Emery Celli Cuti Brinckerhoff & Abady, P.C., T.C. Memo. 2018-55

Law firm ceased operating as a partnership and reorganized as a professional corporation. For convenience, both firms stayed active with the intent of eventually getting rid of the partnership. The payroll service erroneously made a deposit under the partnership EIN that should have been made for the corporation. IRS went after the corporation for the money but would not refund the money paid for the partnership because the statute of limitations had run.

The Tax Court allowed the corporation to apply the equitable recoupment doctrine to get the tax deposit refunded that was erroneously applied to the partnership.

The Tax Court held the settlement officer abused his discretion in failing to consider Emery PC's letters and the supporting documentation it provided after the hearing even though they were submitted late. The court further held that Emery PC established all of the elements of equitable recoupment and could recoup Emery LLP's employment tax overpayment for the first quarter of 1999 to offset its unpaid employment taxes for that period. However, to the extent that Emery PC's underpayment exceeded Emery LLP's overpayment of employment tax for that quarter, the IRS's determination to collect the tax by levy was upheld.

IV. Shareholders Have Transferee Liability for Corporate Tax In Midco Transaction Lacking Economic Substance

Slone v. Commissioner, No. 16-73349 (9th Cir. July 24, 2018)

The Ninth Circuit reversed a Tax Court decision involving an asset and stock sale and a third party because it had no economic substance and was designed as a tax avoidance scheme. In *Slone v. Commissioner*, No. 16-73349 (9th Cir. July 24, 2018), the Ninth Circuit held that the so-called Midco transaction lacked independent economic substance and included a constructively fraudulent transfer.

The issue was whether the shareholders of Slone Broadcasting Co., a closely held corporation, were transferees under section 6901 and liable for the company's federal tax obligation after it sold its assets to Citadel Broadcasting Co. and its shares to Berlinetta Inc.

The court said it was clear that the stock sale, with Berlinetta assuming Slone Broadcasting's tax liability and paying amounts that should have been paid in taxes on the asset sale, "operated in substance as a liquidating distribution by Slone Broadcasting to Petitioners, but in a form that was designed to avoid tax liability."

The court also concluded that the record contained "ample evidence" that the shareholders had constructive notice that the entire scheme had no purpose other than tax avoidance.

V. Damages Awarded To Former Employee Against Former Employer Where Former Employer Intentionally Inflated Form 1099 Reporting To Ex- Employee From $38,000 To $159,000

*Angelopoulo v. Keystone Orthopedic Specialists, S.*C., 122 AFTR 2d ¶2018-5028 (D.C. IL 7/9/2018) determined the appropriate damages to be awarded to a taxpayer under Code § 7434(b) where his former associates willfully filed a fraudulent information return (Form 1099-MISC) stating that he had more than $159,000 in taxable income, rather than the approximately $38,000 that should have been reported. The court considered the taxpayer's attorney and accounting fees and expert expenses incurred, including those in the underlying Tax Court proceeding, IRS settlement, and the present district court litigation about his damages due to the false 1099. Damages are the greater of $5,000 or actual damages plus costs and potentially reasonable attorney fees. The award was about $178,000.

VI. Captive Insurance Arrangement Defeated; Policies Not Insurance & Captive Not An Insurance Company

Reserve Mechanical Corp. v. CIR, T.C. Memo. 2018-86 held that Reserve Mechanical Corporation did not qualify as an insurance company for tax purposes, despite having a license from Anguilla to be a captive insurance company, because Reserve Mechanical both failed to meet tax law requirements for risk distribution and because Reserve Mechanical was operated in a way such that it was not in the business of insurance "in the commonly accepted sense." Further, because Reserve Mechanical was not an insurance company, the attempted 953(d) election of the company was invalid, leaving it as a foreign corporation that had not filed the proper returns timely (Form 1120F), and was thus barred from having the ability to take the deductions and expenses. The Court was not persuaded that IRS had previously issued favorable PLR's in 39 similar situations.

VII. Income from Discharge of Indebtedness

Simonsen, 150 T.C. No. 8 (2018)

In *Simonsen,* the taxpayers bought their home with nonrecourse debt. Five years later they moved out and converted their home to a rental property. Not long after, they completed a short sale of the property, and the bank discharged the debt. The taxpayers claimed that the short sale and consequent debt forgiveness were two separate transactions, a sale of the property and a cancellation of the debt secured by the property, and reported a substantial deductible loss and excludable COD income. The IRS determined that it was one sale or exchange, there was no COD income, and there was no loss.

The Tax Court held that the short sale and debt forgiveness were part of one sale or exchange, and the amount realized included the discharged nonrecourse debt. As a result, the taxpayers did not realize any COD income. Additionally, when applying Regs. Sec. 1.165-9(b)(2), there was neither gain nor loss on the sale because the amount realized was greater than the taxpayers' loss basis in the property but less than their gain basis in the property, under that regulation. Finally, the Tax Court found that the taxpayers were not liable for any Sec. 6662 penalties because the IRS did not prove that the examiner had obtained written approval for the penalty from a supervisor as required under Sec. 6751(b)(1) and the taxpayers demonstrated a good-faith attempt to determine the correct tax treatment of the short sale.

VIII. Charitable Contributions – Value Received

In *Triumph Mixed Use Investments III, LLC*, T.C. Memo. 2018-65, the court determined that a real estate development company was not entitled to claim a charitable contribution deduction for its transfer of certain open land to a city. The court found that the transfer was in exchange for the city's approval of the company's development plan, and that the city's approval constituted a substantial benefit that the taxpayer neither reported nor valued when it claimed the charitable contribution deduction. Compare PLR 8421018 where the IRS allowed a deduction for the cost of a highway interchange a taxpayer constructed and contributed to a public highway system, even though the interchange would provide easier access to property the donor developed. In that ruling, IRS found that the value of the donor's remaining property would not be increased substantially in relation to the value of the gift, and that any benefit the donor realized would be small in comparison to the benefit that would accrue to the public from making traffic conditions less dangerous.

IX. Conservation Easements – Value Received

Wendell Falls Development, LLC, T.C. Memo 2018-45

A land developer was not entitled to a charitable deduction for the placement of a conservation easement on acreage bordering parcels of land that it was developing as a residential community because the developer clearly expected to derive a substantial benefit from the easement in the form of an increase in the value of the planned community. The county where the land was located purchased the land from the developer on the condition that a conservation easement be placed on the property, limiting the use of the land to a park. In addition to its conclusion that the developer received a significant benefit, the Tax Court also found the easement did not diminish the property's value since the highest and best use for the land was as a park both before and after the easement.

X. Charitable Contributions – Substantiation

An individual was denied a charitable contribution to the inactive church he founded. Before 2008, the church held weekly services and collected money and clothing to donate to the poor. After the 2008-2009 recession, the taxpayer was forced to seek work out of state, and the church discontinued its weekly services. During the year at issue, the church's only activity was giving away clothing and other items to individuals the taxpayer considered needy. To substantiate the donations, the taxpayer provided a letter on the church's letterhead that he signed. The Tax Court found that the letter failed to meet the substantiation requirements of Sec. 170 for noncash contributions. It also found that letter was unreliable, as it was not contemporaneous because it was sent after the taxpayer had filed his return, and it was signed by the taxpayer, whose testimony the court did not believe was credible. *Davis*, TCM 2018-56.

XI. Individuals' SOL Extension Extended Assessment Date for Their Partnership Income – Pre-2018 Law

Inman Partners v. CIR, TC Memo 2018-114 held that under pre-2018 law, where several individuals who were partners in a partnership each agreed to extend the statute of limitations (SOL) on assessment for any income tax on any return made by or for them "for the period ended Dec. 31, 2000," the extension applied to partnership items from the partnership whose tax year ended Dec. 19, 2000.

The years involved in this case were all subject to pre-2018 law, the TEFRA partnership procedures. IRS has implemented new audit procedures post 2017. The taxpayers were individuals who indirectly owned interests in a sham partnership, Inman Partners' initial and final partnership return was for its short year that ended Dec. 19, 2000. The taxpayers reported large losses from Inman Partners on their individual tax returns for their years that ended Dec. 31, 2000.

IRS audited the taxpayers' 2000 individual returns. IRS and the partners signed consents to extend the statute of limitations for their personal returns for tax years ending Dec. 31, 2000. The partners were in tax trouble at least in part because of the flow-through losses from the partnership, so IRS chose to use Forms 872-I, Consent to Extend the Time to Assess Tax as Well as Tax Attributable to Items of a Partnership. This is a critical fact.

The Forms 872-I that IRS secured included broad language to make clear that the extensions included assessments attributable to partnership items: "Without otherwise limiting the applicability of this agreement, this agreement also extends the period of limitations for assessing any tax (including additions to tax and interest) attributable to any partnership items (see [former Code] section 6231(a)(3)), affected items (see [former Code] section 6231(a)(5)), computational adjustments (see [former Code] section 6231(a)(6)), and partnership items converted to non-partnership items (see [former Code] section 6231(b))."

The forms also provided that the partners and IRS agreed that "[i]ncome tax due on any return(s) made by or for the... taxpayer(s) for the period(s) ended Dec. 31, 2000 may be assessed at any time on or before" June 30, 2005.

IRS finished its audit and issued a final partnership administrative adjustment (FPAA) for Inman Partners a little more than one month before the partners' extended statutes of limitations on assessment would expire. IRS determined in the FPAA that Inman Partners was a sham, so it adjusted all partnership items to zero and asserted accuracy-related penalties for the resulting underpayments. Inman Partners' tax matters partner didn't agree and timely petitioned the Tax Court for readjustment of partnership items.

The only issue before the Tax Court was whether an extension for individual returns for a year that ends on December 31 includes partnership items from a partnership whose tax year ended before December 31 but during the individuals' tax year that ended December 31. In *WHO515 Inv. Partners v. CIR*, TC Memo 2012-316, the Tax court ruled on this issue and said it did. The taxpayers here admitted that they would lose under *WHO515* but argued that *WHO515* was only a Memorandum Opinion and asked the Court to rethink its reasoning.

The court agreed with IRS and its earlier holding in *WHO515* that the extensions covered the partnership items for the partnership's tax year that ended Dec. 19, 2000.

The partners argued that the phrase "any return(s) made by or for... taxpayer(s) for the period(s) ended Dec. 31, 2000," in the Form 872-I doesn't include a return for a taxpayer for a period that ended before December 31, e.g., a partnership return with a tax year that ended Dec. 19, 2000.

The court stated that Forms 872-I may have extended the statute only for the individual returns with tax years that ended Dec. 31, 2000, but Code § 702(a) and Code § 706(a) say that those individual returns had to report any income tax due to partnership items from any of their partnerships whose tax year ended in 2000 on or before December 31. The Court said that the key point to understand was that the IRS forms don't extend the statute for returns but for the assessment of income tax due on those returns. The Code required the partners to report their Inman Partners' partnership items on their individual returns for their Dec. 31, 2000 tax years, and the partners each consented to extend the statute for assessing the income tax due on those returns.

XII. Investment Management for Family Investments as a Trade or Business

Lender Management LLC, T.C. Memo, 2017-246

In *Lender Management LLC*, T.C. Memo. 2017-246, the Tax Court concluded that a taxpayer was engaged in the trade or business of providing investment management services and, therefore, could benefit from having its expenses treated as fully deductible business expenses under Sec. 162 rather than being treated as expenses for the production of income under Sec. 212 subject to the Sec. 67(a) 2%-of-adjusted-gross-income floor for miscellaneous itemized deductions. This is especially true now that miscellaneous itemized deductions are no longer deductible. The court ruled that the operations of the company consisted of activities that were beyond those of an investor even though the clients it provided investment management services to were primarily family entities, and its primary source of income was an allocation of profits (i.e., an incentive allocation, or carried interest) from various partnerships to which it provided these services.

Given the holding in *Lender Management*, investment partnerships, including family investment partnerships, may consider arrangements where a provider of investment management services is compensated via a profits interest versus a fee that may be subject to limitations under Sec. 67, and nondeductible under Sec. 67(g), for any tax year beginning after Dec. 31, 2017, and before Jan. 1, 2026 (TCJA, §11045). It is important to note that the profits interest must have real economic substance to be respected.

XIII. Tuition Waiver Benefit Related to Past Employment Includible In Income

Voigt, T.C. Summary Opinion 2018-25.

The Tax Court held that the value of a tuition waiver a taxpayer's daughter received in 2013 as part of the taxpayer's severance package that he was given when he was laid off in 1991 was includible in his gross income in 2013.

The Tax Court held that the tuition waiver benefit was includible in Voigt's income for 2013. It found that the benefit was not includible in income in 1991 because he had not constructively received it in that year, and it was not excludable from income under Sec. 117 because Voigt was not an employee or someone treated as an employee of the university in 2013. This is interesting since he will get a W-2 for the benefit even though not an employee. Is it taxable for payroll tax purposes if not excluded from income?

XIV. Accounting Method Change Procedures are Revised

The IRS updated the list of changes in accounting method to which the automatic change procedures in Rev. Proc. 2015-13, as clarified and modified, apply (Rev. Proc. 2018-31).

Rev. Proc. 2018-31 is effective for a Form 3115 filed on or after May 9, 2018, for a year of change ending on or after Sept. 30, 2017, that is filed under the automatic change procedures of Rev. Proc. 2015-13, as clarified and modified by Rev. Proc. 2015-33, and as modified by Rev. Proc. 2017-59, and by Section 17.02 of Rev. Proc. 2016-1. Transition rules allow taxpayers who had a non-automatic change in accounting method pending on May 9, 2018, to notify the IRS that they want to have the automatic change procedures apply to their request, if they are eligible to under Rev. Procs. 2018-31 and 2015-13.

All of this provides assistance in taking advantage of changes allowed by TCJA 2017. No doubt more changes are coming.

XV. Estate of Cahill Signals Pro-IRS Position on Estate Tax Value of Intergenerational Split-Dollar Life Insurance

In *Estate of Morrisette v. CIR*, 146 T.C. 171 (2016), the Tax Court upheld the general treatment of intergenerational split-dollar arrangement (e.g., parent's trust owning life insurance policy on child) under the economic benefit regime of the split-dollar regulations for the income and gift tax. However, it did not rule on the estate tax treatment. Some practitioners believe that intergenerational split-dollar arrangements were a good way to reduce the value of an insured decedent’s taxable estate, while producing estate liquidity.

However, *Estate of Cahill v. CIR*, T.C. Memo. 2018-84 (June 18, 2018) suggests that the Tax Court agrees with the IRS assertion that the estate tax value of the rights of a deceased insured in an intergenerational split-dollar life insurance arrangement is at least equal to the cash value of the policy, rather than just the present value of the right to be repaid under the split-dollar agreement. The court in *Cahill* refused to grant summary judgment to the decedent’s estate on these issues, so it is not a firm explanation of how to value the estate’s interest in the policy.

Cahill indicates that the original transfer of the policies on a son and his wife to an irrevocable trust of the father was not for full and adequate consideration, so its position in this case will very likely reflect the ultimate disposition – that the estate tax value of the decedent’s interest in an intergenerational split-dollar arrangement will be equal or close to the policy’s full cash value. If that is true, then there is little or no estate tax benefit to using an intergenerational split dollar arrangement.

XVI. Company That Overfunded Defined Benefit Plan with Age 45 NRA was Liable for Excise Taxes

The Eighth Circuit, affirming the Tax Court, has held that a defined benefit pension plan with a normal retirement age set at age 45 did not properly calculate its deductible contributions, with the result that a portion of the contributions to the plan were nondeductible and thus subject to the section 4972 10% excise tax each year that the plan was funded (2002-2006). The court also rejected the taxpayer's argument that, by not filing a Form 5330 for the years at issue, the taxpayer had effectively made an election under former Code Sec. 4972(c)(7) to disregard the excess contribution. *Pizza Pro Equipment Leasing, Inc. v. CIR.*, 121 AFTR 2d ¶2018-682 (8th Cir. 2018).

XVII. Previously Reduced 2018 HSA Limit of $6,850 Restored to $6,900

Rev Proc 2017-37 reduced the family HSA limit for 2018 for an individual with family coverage to $6,850, a $50 reduction from the limitation previously announced. The Service received many comments regarding the difficulty of complying with the reduced limit, particularly where individuals had made elections for HSA contributions through their employers' cafeteria plan, as well as the cost of correcting the excess contribution of $50.

In response, the IRS issued Rev Proc 2018-27, which provides that, for calendar year 2018, taxpayers may again treat $6,900 as the annual limitation on deductions under Code § 223(b)(2)(B) for an individual with family coverage under a high deductible health plan.

XVIII. Money Transferred to Son (When Parents Maintained and Exercised Control Over Account) Used to Determine Parents' Lack of Insolvency and Taxability on Debt Discharge Income

Hamilton v. Commissioner, T.C. Memo 2018-62 (May 8, 2018) held that money transferred from parent-taxpayers to their son is included in determining the taxpayers' insolvency under tax code Section 108(a)(1)(B) because the taxpayers' had dominion and control over the account. The taxpayers did not prove that their son was not a nominee.

The taxpayers received a discharge of student loan indebtedness but in the same year received a large disability payment. The taxpayers transferred the disability payment to their son but had electronic control over the account and freely transferred money back to themselves to pay household bills. The court concluded that with the son's account, the taxpayers were not insolvent and the discharge of indebtedness is includible in income.

XIX. First Circuit Joins Sixth Circuit & Allows Use of Roth IRA Owned DISC To Avoid Roth IRA Contribution Limit

The First Circuit, reversing the Tax Court, has upheld the taxpayers' use of a domestic international sales corporation (DISC) called Summa Holdings to transfer amounts from a C corporation to Roth IRAs of the two sons of the C corporation's controlling shareholder, with the result that each IRA, initially funded with $3500, exceeded $3 million over a 6 years, despite the applicable contribution limits and Roth eligibility requirements. *Berenson v. CIR*, 121 AFTR 2d ¶2018-634 (1st Cir. 2018).

Summa Holdings previously appealed the Tax Court decision to the Sixth Circuit, which, reversing the Tax Court's decision, held that IRS had no basis for re-characterizing the transactions because the taxpayers had used the DISC and Roth IRAs for their congressionally sanctioned purposes. The other brother, James Jr.'s appeal on this issue, is pending before the Second Circuit.

XX. Tax Court Denies Mileage Deduction and Penalizes Tax Attorney for Inadequate Substantiation; Reconstructed Travel Ledger Fails; Contemporaneous Written Records Are Best

Velez v. CIR, T.C. Memo. 2018-46 (2018) denied a tax attorney's deduction for vehicle expenses because the expenses were inadequately substantiated. The attorney maintained multiple offices and traveled between them regularly by car or truck. He did not maintain a contemporaneous written record of his travel, but on his tax return he claimed a business expense deduction of nearly $30,000, which he calculated using the applicable standard mileage rates. The IRS denied the deductions and assessed an accuracy-related penalty, and the attorney petitioned the Tax Court for review.

The court explained that while some business expenses can be estimated, automobile expenses are subject to rigorous substantiation requirements under Code § 274(d). To meet those requirements, taxpayers generally must maintain an account book, diary, log, or similar record, plus documentary evidence such as receipts or bills to establish each element of the expense. In the absence of adequate records, however, an element may be established by the taxpayer's own statement and by other corroborative evidence.

Although the attorney presented the court with reconstructed mileage logs based on entries in his electronic calendar and credit card statements, the court upheld the IRS's determination, concluding that the logs were not "adequate" because they were created years later and "long after he had full present knowledge of…each expenditure or use." The credit card statements and other evidence offered - which notably did not include the electronic calendar - were insufficient to corroborate the purpose and location of the expenditures. Regarding the penalty, the court explained that the reasonableness of a taxpayer's effort depends on the facts and circumstances, including the taxpayer's knowledge, education, experience, and reliance on professional advice. In this case, the attorney offered no evidence of reasonable cause for the failure to maintain satisfactory mileage logs, so the court also sustained the IRS's penalty assessment.

Even though the regulations under Code § 274(d) allow vehicle expense deductions to be established by testimony and "other corroborative evidence," that form of substantiation will often be found inadequate. This also affects employers that provide company cars, or reimburse employees for business use of employees' personal vehicles, because the income exclusions for those fringe benefits rely on either the working condition fringe rules or the accountable plan rules, both of which incorporate the strict substantiation requirements of Code § 274(d) when applied to vehicle expenses. Thus, for employees' income to be excluded, and for employers to properly report and withhold income, employees must provide adequate substantiation.

XXI. Division of Irrevocable Trust into 17 Irrevocable Trusts (One for Each Grandchild) Permitted Without Adverse Income, Gift, Estate or GST Consequences

In PLR 201817016 the IRS permitted the division of one irrevocable trust (established before GST applied) into 17 irrevocable trusts with no adverse tax consequences. The IRS gave the following favorable rulings:

1. After the proposed division and modification of Trust, the Divided Trusts will continue to be exempt from the GST tax.

2. The proposed division and modification of Trust will not cause any of Donor's Grandchildren or any member of their respective Family Lines to be treated as having made any transfer subject to the gift tax.

3. The proposed division and modification of Trust will not cause any portion of the assets of the Divided Trusts to be includible in the gross estate of any of Donor's Grandchildren or any member of their respective Family Lines for purposes of the estate tax.

4. The allocation of the assets and liabilities of Trust in approximately equal shares as described herein, whether done on a pro rata or non-pro rata basis, will not cause Trust, the Divided Trusts, the Grandchildren of Donor, or any member of their respective Family Lines to recognize any ordinary income or loss or capital gain or loss for income tax purposes.

5. The adjusted basis of the assets received by the Divided Trusts will be the same as the respective adjusted basis of the assets held by Trust pursuant to § 1015; and

6. The holding periods of the assets received by the Divided Trusts will be the same as the holding periods of the assets in Trust pursuant to § 1223(2).

XXII. Judgments Against S Corp for Over $100M in Loan Defaults Do Not Increase Shareholder-Guarantor's Basis Where Shareholder-Guarantor Paid Nothing

Phillips v. CIR, 121 AFTR 2d ¶2018-756 (11th Cir. 5/17/2018), affirming the Tax Court, determined that an S corporation shareholder couldn't increase her basis in the corporation on account of the fact that the corporation had over $105 million judgments entered against it, for which she was jointly liable as a personal guarantor. The Court found that the mere fact of the judgments without any accompanying payment by her on the judgments was insufficient to support a basis increase.

XXIII. *Green v. United States* (10th Cir., Jan. 12, 2018)

In *Green v. United States*, the U.S. Court of Appeals for the Tenth Circuit addressed the charitable deduction for a donation of real estate by a trust under IRC Section 642(c). This case highlights the differences between the rules for charitable deductions for estates and trusts under Section 642(c), which are subject to this requirement that the property contributed derive from gross income, and the rules governing charitable deductions for other taxpayers under Section 170. For example, charitable deductions for trusts are unlimited with no carryforward, but must be paid out of income or traceable to income, while deductions for individuals are subject to limits tied to adjusted gross income with a 5-year carryforward.

XXIV. Excess Benefit Taxes – Tax Exempt Entities

Farr, T.C. Memo. 2018-2

The Tax Court held that a taxpayer who was the CEO and a member of the board of directors of a tax-exempt organization engaged in excess benefit transactions that were not corrected within the required period. As a result, the taxpayer was subject to the 25% Sec. 4958(a)(1) tax imposed on the receipt of the excess benefits and the 200% Sec. 4958(b) tax for failure to correct the transactions in a timely manner.

In 2003, Joan Farr founded the Association for Honest Attorneys (AHA) in Kansas as a Sec. 501(c)(3) tax-exempt organization. During 2010, 2011, and 2012, while a member of AHA's board of directors and its CEO, she used the AHA's checking account to make cash withdrawals and purchases from department stores, grocery stores, home improvement stores, and various other places. For tax years 2010, 2011, and 2012, the AHA filed tax returns as a Sec. 501(c)(3) organization and not as a private foundation.

The court found Farr's testimony and evidence supporting her contention were not reliable, credible, or persuasive. Therefore, the court held that the purchases and cash withdrawals were excess benefit transactions subject to the 25% tax. The court also found that she had not corrected those transactions within the taxable period; therefore, Farr was also subject to the 200% tax.

XXV. Estranged Spouse Has No Rights to Participant's Plan Account Assets Wired from His Account Before His Death but Received by Payee Trust After his Death

Wengert v. Rajendran, No. 16-4571 (8th Cir. April 3, 2018).

Timothy J. McConnell, in the midst of a divorce proceeding, was in the end stage of terminal cancer, and he had previously advised that all of his ESOP benefits had been distributed. However, it was discovered that a portion of his account remained in the ESOP and on the Friday preceding his death on Sunday, the attorney had him sign documents directing a distribution of all remaining benefits. On the same day, the Plan Administrative Committee wired funds, but Mr. McConnell's trust, the beneficiary, did not receive the funds until Monday, one day after his death.

The issue was whether Mr. McConnell had a remaining Accrued Benefit as of his date of death which would have gone to his divorcing spouse as beneficiary.

The United States District Court for Nebraska entered a strong decision stating that Mr. McConnell had no Accrued Benefit in the ESOP as of his date of death. The plan gives the administrative committee "the sole and exclusive power and discretionary authority ... [t]o determine the rights of Participants or Beneficiaries to benefits under the Plan, the amount thereof, and the method and time or times of payment of the same." The Eighth Circuit found that the ESOP Plan Administrative Committee's decision was within their power and administrative authority and that all funds were transferred out of Mr. McConnell's plan account on Friday, September 12. Furthermore, at the point of transfer of the remaining Accrued Benefit, the plan had satisfied all obligations to Mr. McConnell or his spouse as beneficiary and the Committee determined that the relevant inquiry is not when the funds are received by a Participant but rather when the funds are transferred out of a plan. The Eighth Circuit concluded that the Plan Administrative Committee reasonably explained its interpretation of the plan and relied on substantial evidence to deny the claim of the estranged spouse because at his death, the participant's account had no assets.

XXVI. IRA Exemption from Creditors Upheld After Post 59 ½ Withdrawal, Use of Funds to Purchase Residence, and Rollover Repayment Within 60 Days

A Chapter 13 trustee's objection to taxpayer's bankruptcy estate exemption of his IRA was rejected by the bankruptcy court. The taxpayer-debtor, who was over age 59-1/2, made pre-petition withdrawal from IRA of $327,978.13 and used those funds to purchase a home jointly with his wife in their names, not in the name of the IRA. The court held that this didn't destroy IRA's Code § 408 qualification status or result in a Code § 4975(c) prohibited transaction because the taxpayer was entitled to take distributions without penalty due to age and that he repaid most of those funds within 60-day rollover period, and paid any required taxes on rest of the IRA distribution that was not repaid to the IRA. The court ruled, contrary to the bankruptcy trustee's assertion, that this was not a loan from the IRA but rather a permitted distribution and repayment within the 60 day rollover period.

The Tennessee retirement plan exemption was in play as Tennessee has opted out of the federal exemptions. But the court noted: "The net effect is that, regardless of whether a state opts in or out of the rest of the federal exemptions, retirement funds have a special exempt status under the Bankruptcy Code." The Tennessee exemption statute references Section 408 of the Internal Revenue Code, as does Section 522(b)(4)(D)(ii) of the Bankruptcy Code. The legislative history of Section 522(b)(3)(C) of the Bankruptcy Code indicates that the section was added so that states that opt out of the federal exemption scheme would be provided identical exemption rights in retirement funds for debtors.

While trustee argued that there were additional restrictions on how distribution could be used, the bankruptcy court found that overriding requirement for rollover rule was simply that rollover occur within specified time period, and wasn't dependent on how money was used in the interim, wasn't limited to merely facilitating portability from one IRA to another, and didn't require that rollover be effected with exact same funds. See *In Re Chaudury*, No.16-05574 (Bktcy. M.D. TN, Feb. 1, 2018).

XXVII. Filing Status for Married Taxpayers

Camara, 149 T.C. No. 13 (2017)

Knez, T.C. Memo. 2017-205

The Tax Court, reversing its holding in prior cases and following two earlier circuit court decisions, held that rules barring married taxpayers from changing their filing status from separate to joint do not extend to a return originally filed as single but later switched to joint.

The Tax Court held that a single return was not a separate return for purposes of Sec. 6013(b). As such, it determined that Camara and his wife could file a joint return for 2012. In reaching this conclusion, the court noted that Sec. 6013(b)(1) describes the filing of a separate return as an election and that two circuit courts had earlier held that filing a return with an erroneous and impermissible filing status does not constitute an election for this purpose.

Less than a month later, the Tax Court applied the same reasoning in *Knez*, T.C. Memo. 2017-205, holding that a married taxpayer who erroneously claimed head-of-household status could subsequently file an amended joint return with her husband for the same tax year, enabling them to claim an earned income tax credit.

XXVIII. Mortgage Broker is Not a Real Estate Professional

A mortgage broker was not a real estate professional and therefore was subject to the passive activity loss rules of Sec. 469 (*Hickam*, T.C. Summ. 2017-66). During the years at issue, Kurt Hickam brokered real estate mortgages and other loans secured by real estate, both as an independent contractor and as an employee. He was a licensed real estate agent, but he did not operate, develop, redevelop, construct, reconstruct, or rent real estate in brokering mortgages or originating loans. He did, however, manage and maintain various properties owned by himself and family members. Services that he provided for the properties included placing ads, processing applications, inspecting conditions, and overseeing repairs and remodels. He received $6,000 annually for these services but did not keep contemporaneous records of the hours spent.

The court held that Hickam's mortgage brokerage services and his loan origination services did not constitute real property trades or businesses under Sec. 469(c)(7)(C). While the brokered loans were secured by real property, Hickam's services did not involve operating the real properties. Further, the court held that, while his mortgage brokerage services were a brokerage trade or business, they were not a real property brokerage trade or business, as he did not broker real estate, only loans.

XXIX. COD Income Not Includible in Income Due to Lack of a Bona Fide Debt

Bullock, T.C. Memo. 2017-219

The Tax Court held no bona fide debt existed with respect to a taxpayer because she was only a guarantor on a loan that gave rise to purported cancellation-of-debt (COD) income, even though a Form 1099-C, Cancellation of Debt, was issued to her. Therefore, she did not have to include the COD amount in gross income.

The adult son and daughter-in-law of the petitioner operated a business hauling cars across the country. Due to a business emergency in 2007, they sought a loan to purchase a used pickup truck for their business. Although petitioner intended to serve as a co-signer for her son, she unknowingly signed paperwork that made her the primary obligor on the loan. However, the credit union dealt only with the son and daughter-in-law.

The truck was stolen in 2008. After the credit union was paid by the insurance company, the petitioner's son and daughter-in-law stopped making loan payments on the remaining balance. The outstanding balance on the loan, which was $8,164, was discharged.

Petitioner received a Form 1099-C from the credit union indicating that she received COD income of $8,164 for the 2013 tax year. However, petitioner did not report the COD income on her 2013 federal income tax return. On Jan. 19, 2016, the IRS issued a notice of deficiency determining that she had unreported COD income of $8,164. Petitioner timely filed a petition with the Tax Court for redetermination and appeared pro se.

After considering the relevant facts, the Tax Court held that the transaction at issue did not create a bona fide debt of the petitioner. The court found that when petitioner signed the paperwork, she did not intend to be the primary obligor on the loan.

Tax Court held that the transaction in this case did not create a bona fide debt. Petitioner, with the knowledge of the credit union, operated as a guarantor for her son and daughter-in-law. Additionally, the court held that because she was merely the secondary obligor, her net worth was not increased. Therefore, Petitioner did not receive $8,164 in COD income in 2013.

XXX. Dispute Between Shareholders Did Not Strip Taxpayers of Beneficial Rights of Ownership

Enis, T.C. Memo. 2017-222

The Tax Court held that the taxpayers' poor relations with other shareholders of an S corporation did not affect their ownership interest in the corporation, so the taxpayers were required to include their pro rata share of its income and other tax items on their joint return. Further, one of the other shareholder's alleged misappropriation of funds from the S corporation did not give rise to a theft loss deduction for the taxpayers.

A taxpayer cannot get out of the tax implications of the ownership of an interest in an S corporation simply because of disputes with another shareholder. Absent an agreement among the shareholders that allows one shareholder to strip the beneficial ownership from another shareholder, or a provision in the corporation's governing articles to that effect, the aggrieved shareholder continues as the beneficial owner of the S corporation shares and is responsible for a pro rata share of the S corporation's income and other tax items.

XXXI. Grecian Magnesite

Grecian Magnesite Mining, Industrial & Shipping Co., SA, 149 T.C. No. 3 (2017)

A foreign corporation acquired an interest in a U.S. partnership that engaged in U.S. mining. Several years later, the U.S. partnership redeemed the foreign corporation's interest in the U.S. partnership. The question raised in this case was whether the gain recognized by the foreign corporation on the redemption from the U.S. partnership was effectively connected income and thus U.S. taxable income. Taxpayer took the position that the aggregate theory of partnership does not apply and that IRS Rev. Proc. 91-32, which looks through to the assets of the partnership, is incorrect. The foreign corporation did not report any of the gain as effectively connected income, even though the parties agreed that approximately one-third of the gain was attributable to a U.S. real property interest treated as U.S.-source income.

In *Grecian Magnesite*, the Tax Court ruled that the gain resulting from the redemption of the taxpayer's partnership interest in real property was subject to U.S. income tax. However, the court ruled that the remaining gain was a capital gain that was not U.S.-source income and was not effectively connected with a U.S. trade or business under Secs. 731(a), 736(b)(1), 741, and 865 because the gain arose from personal property in the form of an indivisible capital asset.

The Tax Court rejected Rev. Rul. 91-32; instead, it determined that the entity theory applied to gains and losses under Sec. 741. The court ruled that there is no explicit exception to the entity treatment for purposes of applying Secs. 865 and 864. The court then considered the application of Sec. 864(c)(5). The court found that the office of the U.S. partnership was not a material factor in *Grecian's* recognition of gain from the redemption. Because the court held that the disputed gain was not attributable to a U.S. office or other fixed place of business, it was therefore not U.S.-source income under Sec. 865(e)(2)(A) and not taxable in the United States.

XXXII. Discharge of Indebtedness Income

Kohn, T.C. Memo. 2017-159

In *Kohn*, the taxpayer was a partner in a partnership, which settled all of its debt for less than its basis, resulting in discharge-of-indebtedness income. The IRS determined that the taxpayer must report ordinary income from the discharge of indebtedness. In addition, the taxpayer had a capital gain for the deemed cash distribution related to the decrease of his share of the partnership's liabilities. Lastly, because the taxpayer's basis would be reduced to zero by the deemed cash distribution, the taxpayer would not have had adequate basis to deduct the loss allocated to him by the partnership.

The taxpayer argued that he was not personally liable for any of the partnership's debts, and as a result, he had no partnership liability from which he could have been relieved. He contended that because he was not personally liable for the debt, the discharge-of-indebtedness income that the partnership allocated to him lacked substantial economic effect under Sec. 704(b)(2). Therefore, this income should be reallocated to the other partners. Likewise, because he was not liable for the debt, the taxpayer argued, he did not receive a deemed cash distribution triggered by Sec. 752(b).

The court found that the taxpayer's contention had no merit. Thus, the court found that the taxpayer must report his share of the discharge-of-indebtedness income. Likewise, the court found that under Sec. 752, a partner does not have to be personally liable to be allocated his or her share of partnership debt; thus, the taxpayer would have to report a capital gain for the deemed cash distribution, which exceeded his basis. Because the deemed cash distribution reduced his basis to zero, none of the loss allocated to him by the partnership was deductible under Sec. 704(d).