# Recent Developments in Federal Income Taxation

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## Wasco Real Properties I, LLC v. Commissioner, 744 Fed. Appx. 534 (9th Cir. 12/13/16)

***Outline: item B.1.a, page 9***

- Three tax partnerships purchased land, a portion of which they used to grow almond trees.
- The partnerships paid interest on loans incurred to finance the purchase, and paid property taxes on the land.
- Issue:
  - Are the interest and property taxes paid by the partnerships capital expenditures under the uniform capitalization rules of § 263A?
- Held: Yes, as to the interest and property taxes corresponding to the portion of the land on which almond trees were grown. Growing the almond trees is a production of those trees within the reach of section 263A.

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## Patients Mut. Assist. Collective Corp. v. Commissioner, 151 T.C. No. 11 (11/29/18)
### *Outline: item B.2, page 9*

- Section 280E disallows any deduction or credit otherwise allowable if:
  - such amount is paid or incurred in connection with a trade or business "if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances …."
- The taxpayer, a subchapter C corporation, was engaged in a medical marijuana business in California.
- Issues:
  1. Does § 280E disallow deductions only for businesses that exclusively traffic in controlled substances?
  2. Can a business subject to § 280E include indirect costs in CGS pursuant to § 263A?
- Held: (1) No. Section 280E applies even if a business engages in other activities. (2) No. A business subject to § 280E cannot use § 263A and must determine CGS under the rules of § 471. 3

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## Costs of Entertainment 2017 TCJA § 13304
### *Outline: item D.3, page 11*

- TCJA § 13304 amends Code § 274(a) to disallow business deductions for:
  1. Costs "[w]ith respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation."
  2. Membership dues with respect to any club organized for business, pleasure, recreation or other social purposes.
- Applies to taxable years beginning after 2017.
- Notice 2018-76, 2018-42 I.R.B. 599 (10/3/18).
  - Treasury and IRS will issue proposed regulations.
  - Meals are still deductible (subject to 50% limit) if, among other requirements, taxpayer (or employee) is present and meal is provided to current or potential business customer, client, consultant, or similar business contact. 4

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## Notice 2018-76
## 2018-42 I.R.B. 599 (10/3/18)
## *Outline: item D.3.a, page 12*

- Taxpayers may deduct 50 percent of an otherwise allowable business meal expense if:
  1. The expense is an ordinary and necessary expense under § 162(a) paid or incurred during the taxable year in carrying on any trade or business;
  2. The expense is not lavish or extravagant under the circumstances;
  3. The taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;
  4. The food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and
  5. In the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

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## Notice 2018-76
## 2018-42 I.R.B. 599 (10/3/18)
## *Outline: item D.3.a, page 12*

- Example 1.
  1. Taxpayer A invites B, a business contact, to a baseball game. A purchases tickets for A and B to attend the game. While at the game, A buys hot dogs and drinks for A and B.
  2. The baseball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by A. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game.

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## Notice 2018-76
## 2018-42 I.R.B. 599 (10/3/18)
## *Outline: item D.3.a, page 12*

- Example 2.
  1. Taxpayer C invites D, a business contact, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food and beverages.
  2. The basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages also is an entertainment expense that is subject to the § 274(a)(1) disallowance. Therefore, C may not deduct any of the expenses associated with the basketball game.

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## Notice 2018-76
## 2018-42 I.R.B. 599 (10/3/18)
## *Outline: item D.3.a, page 12*

- Example 3.
  1. Assume the same facts as in Example 2, except that the invoice for the basketball game tickets separately states the cost of the food and beverages.
  2. As in Example 2, the basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game.

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## Qualified Transportation Fringes Disallowed
## 2017 TCJA § 13304
## *Outline: item D.4, page 13*

- No deduction for qualified transportation fringes (employee parking, transit passes, transportation in commuter highway vehicle)
  - Applies to amounts paid or incurred after 2017
  - Ability of employees to exclude transportation fringes <u>not</u> affected
  - Exception: qualified bicycle commuting reimbursements before 2026 are:
    - Deductible by employer
    - Included in income of the employee
- <u>Note</u>: UBTI of tax-exempt organizations is increased if they provide nondeductible qualified transportation fringes. **[Outline page 82, item A.4.b].**

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## Notice 2018-99
## 2018-52 I.R.B. 1067 (12/10/18)
## *Outline: item D.4.a, page 14*

- Treasury and IRS will issue proposed regulations under § 274 that will include guidance on:
  - Determining nondeductible expenses for qualified transportation fringes
  - Calculation of increased unrelated business taxable income (UBTI) of tax-exempt organizations that provide qualified transportation fringes.
- Provides:
  - Section 274(a) does <u>not</u> <u>disallow</u> amounts an employer pays to third parties for employee parking in excess of the § 132(f)(2) monthly limitation on exclusion ($260 for 2018 and $265 for 2019), and employer must treat excess amount as compensation and wages to the employee.
  - If a taxpayer owns or leases parking facilities where employees park:
    - Nondeductible portion of the cost of providing parking can be calculated using any reasonable method.
    - The notice provides a four-step methodology that is deemed to be a reasonable method.

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## Estate of McKelvey v. Commissioner, 148 T.C. No. 13 (4/19/17)
## *Outline: item A.2, page 28*

- The decedent was the founder and CEO of Monster Worldwide, Inc. (known for the website monster.com).
- The decedent entered into variable prepaid forward contracts with two investment banks.
  - In exchange for up-front cash payments, the contracts required decedent to deliver on future settlement dates a number of Monster shares determined by a formula.
  - These contracts qualified for open-transaction reporting.
- The contracts were later modified to extend the settlement dates.
- Issue: did the modification result in either: (1) a taxable exchange of the original VPFCs for extended VPFCs, or (2) constructive sale of the underlying Monster shares under § 1259?
- Held: No. A taxable exchange requires the transfer of "property," which these contracts were not.



## Estate of McKelvey v. Commissioner, 906 F.3d 26 (2d Cir. 9/26/18)
## *Outline: item A.2.a, page 29*

- Reverses and remands to the Tax Court
- The extension of the original contracts could give rise to short-term capital gain as a "termination" under § 1234A.
- Using probability analysis, held that a constructive sale of the underlying Monster shares occurred under § 1259.
  - Remands for determination of amount of long-term capital gain on the constructive sale.

## Moving Expenses
## 2017 TCJA § 11048 and 11049
## *Outline: item A.2, page 35*

- Moving expenses in connection with work not deductible (Code § 217)
- Reimbursements (qualified moving expense reimbursements) not excludable by employees (Code § 132(g))
- Applies to taxable years beginning after 2017 and before 2026
- Exception: members of armed forces on active duty who move pursuant to military orders
- Note: Some churches require ministers to move every few years – may make pastor moves more expensive for churches going forward

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## Notice 2018-75
## 2018-41 I.R.B. 556 (9/21/18)
## *Outline: item A.2.a, page 35*

- Notice 2018-75:
  - The suspension of the exclusion for moving expenses does not apply to individuals who receive reimbursements from employers in 2018 for expenses incurred in connection with moves that occurred before 2018.
  - Applies whether employer pays moving expense directly or reimburses individual.
  - Employers who have included such amounts in an individual's wages or compensation for purposes of federal employment taxes (and withheld and paid federal employment taxes on these amounts) can use the normal adjustment or refund processes to correct the overpayment of federal employment taxes.

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## Felton v. Commissioner, T.C. Memo. 2018-168 (10/10/18)

## *Outline: item B.5, page 43*

- The taxpayer was the pastor of a sizeable church in Minnesota.
- The church had an envelope system for collecting offerings. White, gold, and blue envelopes where used.
  - White: congregant could indicate the portion of any contribution which the congregant desired to be paid by the church to the taxpayer-pastor.
  - Gold: tax-deductible contributions to special programs and retreats conducted by the church.
  - Blue: nondeductible "gifts" to pastor.
- Issue: is the blue envelope money an excludable gift under section 102(a), or instead included in the pastor's gross income?
- Held: gross income. Four factors:
  - Average congregant made blue-envelope donations to keep the taxpayer-pastor;
  - Lack of emphasis in church services that blue-envelope monies were "gifts" to pastor;
  - Routinized structure of the blue-envelope system for the taxpayer's benefit; and
  - Ratio of the taxpayer's salary to the purported blue-envelope "gifts."

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## Notice 2018-70 2018-38 I.R.B. 441 (8/28/18)

## *Outline: item D.1.a, page 44*

- The 2017 Tax Cuts and Jobs Act added § 151(d)(5), which reduces the exemption amount to zero for TY beginning after 2017 and before 2026.
  - Eliminates the deduction for personal exemptions authorized by § 151(a).
- However, it is still necessary to determine for various purposes whether an individual is a "dependent" within the meaning of § 152.
  - Qualifying child
  - Qualifying relative:
    - To be a qualifying relative, § 152(d)(1)(B) requires the individual's gross income for the calendar year be less than the exemption amount as defined in § 151(d).
    - Notice 2018-70: "because it would be highly unusual for an individual to have gross income less than zero, virtually no individuals would be eligible as qualifying relatives."
- Notice 2018-70:
  - Proposed regulations will be issued.
  - In determining eligibility in 2018 for head-of-household filing status and for the new $500 credit (§ 24(h)(4)) for dependents other than a qualifying child, an individual must have gross income not exceeding $4,150 (to be adjusted for inflation).

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## Deduction of State and Local Taxes
### *Outline: item D.2, page 44*

- TCJA: An individual's itemized deductions on Schedule A for state taxes cannot exceed $10,000.
  - Applies to aggregate of property taxes, and sales or income taxes.
  - Limit applies both to single individuals and married individuals filing jointly
  - Applies 2018 through 2025
- Some states have adopted workarounds, e.g., New Jersey gives a credit against property taxes for contributions to certain charitable funds designated by the state.
- Notice 2018-54 (5/23/18): proposed regulations will "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."

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## Deduction of State and Local Taxes
### *Outline: item D.1.b, page 45*

- Proposed regulations: 83 Fed. Reg. 43,563 (8/27/18).
  - Apply to contributions *after* 8/27/18.
- The proposed regulations:
  - Generally require taxpayers to reduce the amount of any federal income tax *charitable contribution deduction* by the amount of any corresponding state or local tax *credit*.
    - Provide an exception: a 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.
    - Example: T contributes $1,000 to state charity and gets 10% state tax credit.
  - Provide that a *state or local tax deduction* normally will *not* reduce a taxpayer's federal *deduction* (provided the state and local deduction does not exceed the taxpayer's federal deduction).

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## Deduction of State and Local Taxes
## IRS News Release IR-2018-178 (9/5/18)
## Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (12/29/18)
## *Outline: item D.1.c-d, page 46*

- This News Release provides:
  - 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 regardless of whether the taxpayer is doing business as a sole proprietor, partnership or corporation.
- Rev. Proc. 2019-12:
  - Sets forth safe harbors for C corporations and "specified passthrough entities."
  - General principle: the taxpayer's federal charitable contribution deduction is reduced by any state tax credit, but the balance of the payment can be a business expense deduction under § 162 if the payment is made with a business purpose.

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## Hargis v. Koskinen,
## 893 F.3d 540 (8th Cir. 6/22/18)
## *Outline: item D.2, page 50*

- Held: debt of an S corporation to third parties does not increase a shareholder's basis, even if the shareholder is a guarantor or co-obligor on the loan.

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## Summa Holdings, Inc. v. Commissioner, 848 F.3d 779 (6th Cir. 2/16/17)
### *Outline: item H.1, page 52*

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



## Mazzei v. Commissioner, 150 T.C. No. 7 (3/5/18)
### *Outline: item H.1.b, page 53*

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

## Benenson v. Commissioner,
## 887 F.3d 511 (1st Cir. 4/6/18)
## 910 F.3d 690 (2d Cir. 12/14/18)
## *Outline: item H.1.c-d, page 54-55*

- Shareholders in the *Summa Holdings* case appealed the Tax Court's decision to the First and Second Circuits.
  - The Sixth Circuit ruled on the tax consequences <u>to the C corporation</u> that operated the family business.
  - These shareholders resided in the First and Second Circuits.
- The First and Second Circuits followed the Sixth Circuit in rejecting application of the substance over form doctrine.
- <u>Held</u>: the shareholders are <u>not</u> treated as receiving a deemed distribution and as making an excess Roth IRA contribution.

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## Ginsburg v. United States,
## 136 Fed. Cl. 1 (1/31/18)
## *Outline: item G.1.a, page 69*

- The taxpayer held 90% of the membership interests in an LLC classified as a partnership for federal tax purposes.
- The LLC participated in New York State's Brownfield Development Tax Credit program.
  - In return for acquiring an abandoned shoe factory and restoring it as residential property, the LLC received state tax credits.
  - Any credit in excess of state tax liability is paid in cash.
  - The LLC received $1.8 million from New York State as an "excess" credit payment.
- <u>Issue</u>: is $1.8 million payment included in the LLC's (and therefore its partners') gross income?
- <u>Held</u>: Yes. The payment was an accession to wealth (*Glenshaw Glass* (U.S. 1955). The court rejected arguments that the payment was a nontaxable (1) contribution to capital, (2) recovery of investment, or (3) general welfare grant.

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## Uniquest Delaware, LLC v. United States, 294 F. Supp. 3d 107 (W.D.N.Y. 3/27/18) *Outline: item G.1.b, page 70*

- Held: An $11 million grant from New York State received by an LLC classified as a partnership for federal tax purposes was included in the LLC's (and therefore the partners') gross income.
  - The grant was for restoration of a building in Buffalo.
  - The court rejected the argument that the grant was a nontaxable contribution to capital because § 118 applies only to corporations.
  - Planning idea:
    - The LLC had two members, each of which was a disregarded LLC held by a subchapter S corporation.
    - Had the grant been paid to the S corporations and then contributed to the LLC, the S corporations could have excluded the grant from gross income (at least under the pre-TCJA version of § 118).

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## Selected Highlights of the Tax Cuts and Jobs Act

- Changes Affecting Exempt Organizations
  - Changes to UBIT rules. **[p. 80, A.4]**
    - Notice 2018-67 (8/21/18) **[p. 81, A.4.a]**
    - Notice 2018-99 (12/10/18) **[p. 83, A.4.b]**
    - Notice 2018-100 (12/10/18) **[p.83, A.4.c]**

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## Recent Conservation Easement Decisions

- PBBM Rose Hill, Ltd. v. Commissioner, 900 F.3d 193 (5th Cir. 9/14/18). **[p. 88, B.4]**
- Pine Mountain Preserve, LLLP v. Commissioner, 151 T.C. No. 14 (12/27/18). **[p. 89, B.5]**

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## Gregory v. Commissioner, 152 T.C. No. 7 (3/13/19)

## *Outline: item D.1, page 101*

- Taxpayers moved in June 2015.
  - October 2015: filed 2014 tax return using old address
  - November 2015: submitted POA on Form 2848 with new address
  - April 2016: filed extension request (Form 4868) for 2015 with new address
- Oct. 2016: IRS mailed notice of deficiency for 2014 to old address.
  - Taxpayers did not become aware of SNOD until after 90-day period for filing petition in the Tax Court.
  - Filed their Tax Court petition late
- Issue: had the IRS mailed the notice of deficiency to taxpayers' last known address, as required by § 6212(b)(1)?
- Held: Yes. Last known address is address on most recently filed tax return, unless IRS is provided with clear and concise notification of new address. Neither Form 2848 nor Form 4868 provided notice.

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## Weiss v. Commissioner, 121 A.F.T.R.2d 2018-783 (D.C. Cir. 5/22/18) *Outline: item F.1.a, page 105*

- Held: when the date of a Final Notice of Intent to Levy is earlier than the date of mailing, the 30-day period for the taxpayer to request a collection due process hearing runs from the date of mailing.

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## Melasky v. Commissioner, 151 T.C. No. 8 (10/10/18) and 151 T.C. No. 9 (10/10/18) *Outline: item F.7, page 108*

- The taxpayers hand-delivered to the Service at the Service's office in Houston a check for $18,000 and requested that the check be applied against their 2009 federal income tax liability.
- A few days later, the Service levied against the bank account on which the check had been drawn and applied the proceeds of the levy to an earlier tax year. Therefore, the check bounced.
- The taxpayers had a CDP hearing. The IRS settlement officer determined that the levy proceeds were an involuntary payment that the IRS was free to apply as it wished.
- Held:
  1. The standard of review in Tax Court is for abuse of discretion, not (as the parties had agreed) *de novo*. The underlying tax liability was not at issue.
  2. The levy proceeds were an involuntary payment that the IRS could apply to earlier years.
  3. The IRS did not abuse its discretion in rejecting the taxpayers' proposed partial-pay installment agreement.

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## FBAR Penalties
## Outline: item H.11, page 121

- Under 31 U.S.C. § 5321(a)(5)(A), the Secretary of the Treasury "may impose" a penalty for FBAR violations.
  - Pursuant to administrative orders, the authority to impose FBAR penalties has been delegated by the Secretary to the IRS.
- Maximum penalties:
  - Before the American Jobs Creation Act of 2004 ("AJCA"), 31 U.S.C. § 5321(a)(5) provided that the penalty for *willful* FBAR violations was the greater of $25,000 or the balance of the unreported account up to $100,000.
  - After the AJCA of 2004, the *normal* penalty for an FBAR violation is $10,000 per offending account, but the penalty for a *willful* FBAR violation "*shall be increased to the greater of*" $100,000 or 50 percent of the balance in the offending account at the time of the violation.
- The relevant regulation, 31 C.F.R. § 1010.820(g), reflects pre-ACJA law and caps the penalty for willful FBAR violations to $100,000 per account.
- Issue: can the government impose the higher, current statutory penalty?
  - No. *United States v. Colliot*, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18).
  - No. *United States v. Wadhan*, 325 F. Supp. 3d 1136 (D. Colo. 7/18/18).
  - Yes. *Norman v. United States*, 138 Fed. Cl. 189 (7/31/18).

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