Recent Developments in Federal Income Taxation

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May 7, 2018

Selected Highlights of the Tax Cuts and Jobs Act

- Accounting
  - Increased ability of C corporations to use cash method [p.4, A.2]
    - C corporations, and partnerships with C corporation partners, can use cash method if average annual gross receipts over 3 prior years do not exceed $25 million.
    - Applies even if inventory is material income-producing factor.
    - Change in accounting method treated as made with IRS consent.
  - Expanded exception to the UNICAP rules [p.7, D.2]
    - Available to taxpayers who meet the $25 million gross receipts test (above).
    - Available to those who produce and those who acquire for resale
  - Revenue recognition by accrual method taxpayers [p. 7, D.3]
    - No later than recognized in "applicable financial statement"
    - Codification of deferral method for advance payments

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Vest v. Commissioner, 119 A.F.T.R.2d 2017-2043 (5th Cir. 6/2/17)

Outline: item C.1.a, page 6

- The taxpayers owned an interest in Truebeginnings, LLC, an accrual basis partnership, which owned interests in two other partnerships, referred to as VAS and Metric.
- Truebeginnings:
  - Sold computer equipment and zero-basis intangibles to VAS and Metric in exchange for 10-year promissory notes
  - Used the installment method to report > $3 million of gain
- Issue: did § 453(g)(1)-(2) disallow the installment method? Disallowance occurs for sales of depreciable property between related persons unless it is established that the disposition did not have tax avoidance as one of its principal purposes.
- Held: Yes. The substance of the transaction revealed a tax avoidance purpose.

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Selected Highlights of the Tax Cuts and Jobs Act

- **Business**
  - **No deduction for entertainment [p.9, D.2]**
  - **No deduction for qualified transportation fringes [p.10, D.3]**
  - **New deduction for 20 percent of "qualified business income" for sole proprietors, partners, and S corporation shareholders [p.11, D.4]**
  - **Limited deduction of business interest expense [p.12, D.5]**
  - **Repeal of § 199 deduction for domestic production [p.14, D.6]**
  - **Increased limits and expansion of property eligible for § 179 [p.15, E.1.a]**
  - **100 percent § 168(k) bonus first-year depreciation [p.16, E.1.b]**
  - **Changes to NOL rules [p.20, H.1]**

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Limit on Deducting Business Interest
2017 TCJA § 13301
Outline: item D.5, page 12

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

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Notice 2018-28
2018-16 I.R.B. 492 (4/2/18)
Outline: item D.5.a, page 12

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

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

Outline: item A.1.a, page 22

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

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

Outline: item A.5, page 24

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

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

Outline: item A.6, page 25

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

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Estate of Bartell v. Commissioner, 147 T.C. No. 5 (8/10/16)

Outline: item E.1, page 26

- Bartell Drug, an S corporation, wished to acquire Property 2 and sell Property 1.
  - Ultimately engaged in a reverse § 1031 exchange.
  - Prior to the § 1031 exchange:
    - Arranged for another party to acquire Property 2.
    - Guaranteed financing of renovations to Property 2 and occupied Property 2 as a tenant.
- Issue: Did the exchange of Property 1 for Property 2 qualify as a § 1031 like-kind exchange?
- Held: Yes. Court rejected IRS's argument that Bartell Drug was the owner of Property 2 before the exchange.
- Note: IRS has non-acquiesced. A.O.D. 2017-06, 2017-33 I.R.B. 194 (8/23/17).

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Selected Highlights of the Tax Cuts and Jobs Act

- Investment Gain and Income
  - Like-Kind Exchanges (Section 1031) [p.28, E.2]
    - Limited to real property for taxable years beginning after 2017

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Selected Highlights of the Tax Cuts and Jobs Act

- **Individuals**
  - **Reduced rates of tax on ordinary income [p.44, A.1]**
  - **Little change in capital gain rates [p.45, A.2]**
  - **Increased standard deduction ($24,000 for MFJ) [p.52, D.6]**
  - **No personal exemption deduction [p.52, D.7]**
  - **Limited deduction for state and local property, income, and sales taxes ($10,000) [p.53, D.8]**
  - **Mortgage interest deduction-only $750k acquisition debt [p.53, D.9]**
  - **No deduction for interest on home equity loans [p.53, D.9]**
  - **No deduction for most personal casualty losses [p.54, D.11]**
  - **No deduction for miscellaneous itemized deductions [p.26, C.1]**
  - **Overall limitation on itemized deduction (§ 68) repealed [p.54, D.12]**
  - **Increased child tax credit [p.54, D.13]**
  - **No deduction for alimony (agreements after 2018) [p.56, E.2]**
  - **Increased AMT exemptions and phase-out thresholds [p.57, G.1]** 12

2018 Individual Tax Rates
Outline: items A.1-2, pages 44-45

	Before TCJA	After TCJA
Individual rate brackets	7	7
Lowest individual rate (ordinary income)	10%	10%
Highest individual rate (ordinary income)	39.6%	37%
Rates on long-term capital gain	0%, 15%, 20%	0%, 15%, 20%
Tax on net investment income	3.8%	3.8%

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Mortgage Interest Deduction
2017 TCJA § 11043
Outline: item D.9, page 53

- Prior to TCJA, taxpayers could deduct interest paid on:
  - Up to $1 million of "acquisition indebtedness"
    - Debt used to acquire, construct, or substantially improve principal residence or 1 other residence & secured by residence
  - Up to $100,000 of "home equity indebtedness"
    - Debt secured by residence not used to acquire, construct, or substantially improve the residence
- Limit on acquisition indebtedness reduced from $1 million to $750,000 (effective TYB after 2017 and before 2026).
- Interest on home equity indebtedness no longer deductible (effective TYB after 2017 and before 2026)
  - Potential trap: the cash-out refinance
    - Will result in home equity indebtedness if cash proceeds not invested in the home.

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Child Tax Credit
2017 TCJA § 11022
Outline: item D.13, page 54

- Increased from $1,000 to $2,000 per child
- Refundable portion of credit increased from $1,000 to $1,400 per child
- Phase-out of the credit begins at:
  - MFJ: AGI of $400,000 (increased from $110,000)
  - All others: $200,000 (increased from $75,000 for single filers)
- New nonrefundable credit for dependents other than a qualifying child.
- All provisions apply for tax years beginning after 2017 and before 2026.

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Alimony
2017 TCJA § 11051
Outline: item E.2, page 55

- Prior to TCJA:
  - Alimony is deductible (above-the-line) by the payor
  - Alimony is included in the gross income of the recipient
  - Example: payor earns $100,000 and pays to ex-spouse $50,000 of alimony—each individual is taxed on $50,000
- TCJA: For divorce or separation instruments executed after 2018—
  - Alimony will not be deductible by the payor
  - Alimony will not be included in the gross income of the recipient

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Summary for Individuals

- Lower tax rates
  - More take-home pay for employees because of reduced withholding
- Fewer available deductions and larger standard deduction means more likely to take standard deduction rather than itemize deductions
- No personal exemption deduction
- More likely to benefit from child tax credit

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Example

- Married couple filing jointly
- Two small children
- Both parents work and earn a total of $140,000
- Itemized deductions of $15,000 (mortgage interest, property taxes, charitable contributions)

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Example

	2017	2018
Gross Income	$140,000	$140,000
Standard Deduction		($24,000)
Itemized Deductions	($15,000)	
Personal Exemptions	($16,200)	0
Taxable Income	$108,800	$116,000
Tax	$18,678	$17,399
Child Tax Credit	0	($4,000)
Tax Due to IRS	$18,678	$13,399

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Selected Highlights of the Tax Cuts and Jobs Act

- Corporations
  - Expansion of eligible beneficiaries of, and other limitations on, electing small business trusts **[p.59, D.3]**
  - 21% flat corporate tax rate **[p.69, H.5]**
  - Repeal of corporate AMT **[p.70, H.6]**
  - Reduced corporate dividends-received deduction **[p.70, H.7]**
    - 100% deduction unchanged
    - 80% deduction reduced to 65%
    - 70% deduction reduced to 50%

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Petersen v. Commissioner, 148 T.C. No. 22 (6/13/17)

Outline: item D.1, page 58

- The taxpayers were shareholders of an S corporation that had established an Employee Stock Ownership Plan (ESOP).
  - The ESOP owned shares for the benefit of employees.
- The S corporation used the accrual method of accounting and accrued deductions for > $1 million in wages and vacation pay.
- Issue: were the S corporation's deductions disallowed by the forced matching rule of § 267(a)(2)?
  - This rule defers deductions of an accrual method taxpayer for items payable to a related cash-method taxpayer until the cash-method taxpayer includes the item in gross income.
- Held: Yes. The shares held by the ESOP trust are attributed to the employees who, as shareholders, are related to the S corp. pursuant to § 267(e).

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

Outline: item H.1.a, page 64

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

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

Outline: item H.1.b, page 65

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

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Avrahami v. Commissioner, 149 T.C. No. 7 (8/21/17)

Outline: item H.4, page 68

- Two married taxpayers were shareholders of an S corporation that operated jewelry stores. They also held real estate companies.
  - They paid approximately $156,000 per year for commercial insurance.
- The taxpayers entered into a micro-captive insurance arrangement.
  - They formed an insurance company, owned by the wife, in St. Kitts. The company made the § 831(b) election.
  - The company issued P&C insurance to taxpayers' entities and also reinsured terrorism insurance. Existing insurance stayed in force.
  - Annual premiums paid to the company were nearly $1.2 million.
- Held: (1) the arrangement is not insurance and premiums are not deductible; (2) the company was not an insurance company and its § 831(b) election therefore was invalid; (3) $500,000 of company's surplus made available to the taxpayers was includible in gross income. See also Notice 2016-66 (such transactions are "transactions of interest").

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Selected Highlights of the Tax Cuts and Jobs Act

- Partnerships
  - Three-year holding period for carried interests **[p. 70, B.1]**
    - Quirks in its application will require guidance
    - **Notice 2018-38 (3/1/18) [p. 71]:** regulations will take position that statute applies to partnership interests held by S corporations
  - Legislative reversal of Tax Court's 2017 *Grecian Magnesite Mining* decision, which held that a foreign partner was not subject to U.S. tax on the sale of a U.S. partnership interest **[pp. 73-76, D.1.a]**
  - No more technical terminations of partnerships **[p. 76, D.2]**
  - Automatic § 754 election in certain circumstances **[p.77, E.2]**
  - TEFRA out; new partnership audit rules for 2018 **[p.77, F.1]**

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Selected Highlights of the Tax Cuts and Jobs Act

- Exempt Organization Changes
  - New Code § 4960 imposes 21 percent excise tax on portion of compensation that exceeds $1 million paid by "applicable tax-exempt organizations" to "covered employees." **[p. 86, A.4]**
  - New Code § 4968 imposes 1.4 percent excise tax on private colleges and universities with endowments worth $500,000 or more per full-time "tuition-paying" student **[p. 87, A.4.a]**
  - Changes to UBIT rules **[p. 87, A.5]**:
    - New Code § 512(a)(6) prohibits income and losses from separate unrelated business activities from being aggregated
    - New Code § 512(a)(7) increases UBTI by expenses paid or incurred for certain nondeductible fringe benefits

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Rev. Proc. 2018-15
2018-9 IRB 379 (2/8/18)
Outline: item A.8, page 89

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

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Selected Highlights of the Tax Cuts and Jobs Act

- Changes Affecting Charitable Giving
  - Increased limit (60% instead of 50% of contribution base) for *cash* contributions made by an individual to *public charities* and certain other organizations. **[p. 95, B.7.a]**
  - Amendment of § 170(*l*) to preclude a charitable contribution deduction of amounts paid to a college or university for preferred seating at athletic events. **[p. 96, B.7.c]**
    - Effective for amounts paid in taxable years beginning after 2017

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

Outline: item A.2.a, pages 95-97

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

Martin v. Commissioner, 149 T.C. No. 12 (9/27/17)

Outline: item B.4, page 134

- The taxpayers, a married couple, owned a 300 acre farm.
  - Formed a subchapter S corporation and became employees
  - The S corporation contracted to produce young chickens (broilers) for a large poultry producer.
  - Taxpayers leased their farm (excluding their residence and 10 acres) to the S corporation, which paid annual rent to the taxpayers of approximately $260,000.
- Issue: were the rental payments subject to self-employment tax?
- Held: No.
  1. Under § 1402(a)(1), rentals from real estate are excluded from net earnings from self-employment.
  2. Because the taxpayers charged a fair market rent, the exception for rental payments under an arrangement calling for material participation by the owners did not apply.