CURRENT FEDERAL TAX DEVELOPMENTS NOVEMBER 10, 2014

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Section: 36B
Plans that Fail to Offer Significant In-Patient Hospitalization and/or Physician Coverage Will Not Offer Minimum Value

Citation: Notice 2014-69, 11/4/14

In Notice 2014-69 the IRS has issued a warning regarding certain employer health plans it has learned about that have been designed to provide no, or extremely limited, in-patient hospitalization and/or physician coverage but still, due to quirks in the online minimum value calculator, be found to provide "minimum value" for health insurance.

The notice provides that plans that fail to provide significant in-patient hospitalization and/or physician coverage do provide minimum value and that regulations will shortly be issued to that effect.

Under the Affordable Care Act, a "large" employer may owe penalties it fails to provide affordable coverage that provides minimum value to its employees. Thus, the plans described above would not qualify as coverage that would allow an employer to escape the "pay or play" penalty if an employee were to qualify for assistance for a health care program purchased from the state exchange.

However, recognizing that the current regulations allow for such a program, the IRS has announced that if an employer has a pre-November 4, 2014 binding commitment to participate in such a program, the plan will be allowed to use the mechanical minimum value test for 2015 so long as the plan's year begins no later than March 1, 2015.

Section: 199
Software Developer Had DPGR Income Despite Income Being Bsaed on Services Provided to Third Parties by Contracting Parties

Citation: TAM 201445010, 11/7/14

In TAM 201445010 the IRS ruled that a corporation's income from licensing of software to a third party that provided services to other parties constituted Domestic Production Gross Receipts (DPGR) for purposes of the IRC §199 deduction from domestic production. This was true despite the fact that the corporation received its income from a payment made by the licensing entity each that entity used the software to provide a service to a end user.

As the IRS describes the agreements:

> Under master agreements with each of the Contracting Parties, Taxpayer designs and develops unique Computer Software for each Contracting Party's data, and Taxpayer licenses the Computer Software to the Contracting Parties. An End User subscribes to a product or service by entering into a subscriber agreement with both Taxpayer and the respective Contracting Party. Under the subscriber agreement, the End User submits a service request to the Contracting Party, and the Contracting Party uses the licensed computer software and the Contracting Party's data to perform the service (generation and distribution of the Results) with the Results provided by the Contracting Party to the End User. In some cases, Taxpayer grants the End User a license to use the Results. Under the subscriber agreement, the Contracting Party collects End User fees. The Contracting Party pays Taxpayer an amount as provided under the respective master agreement.

The examining agent believe that this arrangement resulted in the entity being paid for a service rather than for the licensing of software, a transfer that would not generate DPGR. The taxpayer argued, rather, that since the entity it licensed the software to was performing the service, the income represented fees for the development of software that were part of DPGR.

The examining agents believed the case was similar to the following examples, whose description in the TAM are reproduced below that are found in the regulations:

> Section 1.199-3(i)(6)(v), Example 1, provides that L is a bank and produces computer software within the United States that enables its customers to receive online banking services for a fee. Under §1.199-3(i)(6)(ii), gross receipts derived from online banking services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, L's gross receipts derived from the online banking services are non-DPGR.
>
> Section 1.199-3(i)(6)(v), Example 2, provides that M is an Internet auction company that produces computer software within the United States that enables its customers to participate in Internet auctions for a fee. Under §1.199-3(i)(6)(ii), gross receipts derived from online auction services are attributable to a service and don ot constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. M's activities constitute the provision of online services. Therefore, M's gross receipts derived from the Internet auction services are non-DPGR.
>
> Section 1.199-3(i)(6)(v), Example 3, provides that N provides telephone services, voicemail services, and e-mail services. N produces computer software within the United States that runs all of these services. Under §1.199-3(i)(6)(ii), gross receipts derived from telephone and related telecommunication services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, N's gross receipts derived from the telephone and other telecommunication services are non-DPGR

The National Office agreed with the taxpayer. The TAM notes:

> Our view of the facts supports the conclusion Taxpayer derived gross receipts from the license of Computer Software to the Contracting Parties, and not from providing services to End Users. In our view, the substance of Taxpayer's relationship with the Contracting Parties is that Taxpayer produces the Computer Software used by the Contracting Parties to provide services to End Users. However, even though LB&I and Taxpayer agree on the facts described above, the parties reach a different conclusion as to which party is paying Taxpayer.

The memorandum goes on to distinguish this case from the examples by noting:

> LB&I compared Taxpayer's situation with those of the taxpayers described in Examples1, 2, and 3 in § 1.199-3(i)(6)(v). These examples illustrate the rule in §1.199-3(i)(6)(ii) and describe situations where a taxpayer producing computer software does not lease, rent, license, sell, exchange, or otherwise dispose of such computer software, but instead uses the computer software to provide online services to customers. The gross receipts are determined to be non-DPGR because the taxpayers are deriving gross receipts from providing services, not from the license of computer software. Taxpayer's facts are different from these examples. Here, Taxpayer licenses (disposes of) the Computer Software to the Contracting Parties, and the Contracting Parties (not Taxpayer) use the Computer Software to provide services to End Users. Thus, the examples do not support the conclusion that Taxpayer's gross receipts are derived from services.

Section: 381
Regulations Provide for Transfer of Earnings and Profits in Certain Corporate Tax Free Transactions

Citation: TD 9700, 11/10/14

In TD 9700, the IRS revised Regs. §1.312-11 and §1.381(a)-1 to clarify that, in general, if a corporation participates in a tax free exchange, distribution or other tax free transfers from one corporation to another as described in IRC §381(a), the corporation that acquires the assets of the transferor corporation will succeed to the transferor's earnings and profits, even if the receiving corporation ultimately retains none of the transferor's assets.

Transfers to which are described in IRC §381(a) are:

- A distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies; or

- A transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1),

The preamble notes that no allocation of earnings is to be made except in those cases where Reg. §1.312-10 applies (which deals with corporate separations).

These regulations are generally the same as the original proposed regulations with one clarifying change the IRS points to in the preamble. The IRS notes:

> The proposed section 312 regulations provided that "[e]xcept as provided in §1.312-10, in all other cases in which property is transferred from one corporation to another and no gain or loss is recognized (or is recognized only to the extent of the property received other than that permitted to be received without the recognition of gain), no allocation of the earnings and profits of the transferor is made to the transferee." These final regulations remove the language "and no gain or loss is recognized (or is recognized only to the extent of the property received other than that permitted to be received without the recognition of gain)." The IRS and the Treasury Department believe this language may inappropriately imply that allocation of earnings and profits may be permitted in cases in which gain not expressly described is recognized on the transfer of property between corporations (for example, gain required to be recognized under section 367 or 1001). This clarifying, non-substantive change confirms that except as provided in §1.312-10, in all other cases in which property is transferred from one corporation to another, no allocation of earnings and profits is made.

The final regulations apply to transaction occurring on or after November 10, 2014.

Section: 469
Portion of Proprietorship Business that was Truly Real Property Trade or Business Not Documented, Taxpayer Denied Real Estate Professional Status

Citation: Cantor v. Commissioner, TC Summary Opinion 2014-103, 11/6/14

Passive activity issues have been the subject of quite a few Tax Court cases over the past year, but in the case of *Cantor v. Commissioner*, TC Summary Opinion 2014-103 the issue in front of the Court was one that doesn't quite as often come up. However, the result was again dictated by the same problem that has dogged taxpayers in far too many of these cases—an inability to offer up documentation to prove the taxpayer met the requirements to obtain a preferential tax result.

The issue in this case was whether Howard Cantor was truly a real estate professional under IRC §469(c)(7) for the year in question. The focus was, this time, on whether Mr. Cantor's full time work for the proprietorship that he owned has hours of service qualifying as "real estate" hours.

Real estate professionals qualify for an exception from the general rule that rental are passive activities under §469(c)(2). If a taxpayer is a real estate professional, the rental activities rather are treated just like any other activity—the taxpayer must still demonstrate material participation, but at least the taxpayer has the opportunity to do so.

To be a real estate professional, a taxpayer must meet the criteria found in IRC §469(c)(7)(B). That section provides:

> (B) Taxpayers to whom paragraph applies
>
> This paragraph shall apply to a taxpayer for a taxable year if
>
> > (i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
> >
> > (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.
>
> In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements. For purposes of the preceding sentence, activities in which a spouse materially participates shall be determined under subsection (h).

Real property trades or businesses are defined at IRC §469(c)(7)(C) which states:

> For purposes of this paragraph, the term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Mr. Cantor operated a proprietorship, ABS Glass, which provided various services. Initially it limited its operations to providing automobile parts, but later expanded its business to include automobile windshield repairs and replacements and, later on, repairs and installation of glass products in buildings, holding a state contractor's license for the final category of work.

Mr. Cantor worked 45 to 50 hours per week in the business, performing the normal functions of a proprietor. So, as the Court noted, he clearly spent more than 750 hours in the business. But he did not maintain any contemporaneous record of how many hours he spent performing activities related to the automotive or residential portion of the business, as well as how much related to general management functions.

The taxpayers contended that the residential operations of ABS Glass were construction or reconstruction activities and that Mr. Cantors hours working in that function were both more than 750 hours and more than half of his personal services for the year.

The Court first looked at whether the taxpayer was correct in holding that all of ABS Glass's residential operations constituted a real property trade or business. The Court did not accept that everything that ABS Glass's residential division did qualified as "construction" or "reconstruction" under IRC §469(c)(7)(C). Noting that neither the statute, regulations or case-law has a clear definition of either term, the Court turned to the terms' general usages and concluded:

> *Webster's II New Riverside University Dictionary* 303 (1984) defines the term "construction" as "[t]he act or process of constructing" and defines the term "constructing" as "[t]o put together by assembling parts". *Webster's II New Riverside University Dictionary* 983 defines the term "reconstruction" as "[t]he actor result of reconstructing" and defines the term "reconstructing" as "[t]o construct again." Nothing in the dictionary definitions limits the terms to real property construction or reconstruction, but the statute expressly imposes such a limitation.
>
> Keeping that limitation in mind, we assume without finding that installing original or replacement windows in newly built or existing buildings constitutes "construction" or "reconstruction" within the meaning of section 469(c)(7). On the other hand, we find that cutting and installing mirrors and table tops, cutting and installing shower and bath glass enclosures, and replacing window panes do not.

So, at best, only a portion of the residential activity of ABS Glass might qualify. However, the Court does not need to worry about this because, it notes, Mr. Cantor has no records to allow any sort of division of time:

> Section 469(c)(7)(B) requires that we compare the time petitioner spent in real property trades or businesses against the time he spent in other trades or businesses during each year in issue. Petitioner explained the services he provided as the sole proprietor of ABS Glass in generalized terms, and his explanation shows that he performed services in real property trades or businesses as well as other types of trades or businesses. He did not keep a contemporaneous log showing how much of his time was spent in any particular activity, and we cannot otherwise make that determination from his testimony or any of the other evidence admitted in this case.
>
> Because petitioner provided services in both real property trades or businesses and other trades or businesses during the years in issue, and because the evidence does not allow for a finding that he spent more time in the real property trades or businesses than he did in the other trades or businesses during either year in issue, he is not an individual described in section 469(c)(7) for either of those years. It follows that the real estate loss deductions here in dispute are subject to the limitations imposed in section 469. Respondent's determinations in that regard are sustained.

So while the issue was different than that of most earlier cases, yet again a taxpayer's failure to keep adequate records of his activities doomed his ability to claim real estate professional status.

Advisers need to counsel client who want to claim this status that a failure to maintain records will almost certainly be fatal to claiming real estate professional status should the issue be raised on examination. As well, taxpayers should be made aware that the large number of cases being seen mean that an even larger number of examinations are taking place where the IRS is questioning this issue.

Finally, if an adviser is face to face with a client who decides that a) he can't be expected to keep such records and therefore won't do so but b) wants the adviser to claim the loss anyway because "I probably won't be audited", the adviser must remember the standards an adviser must adhere to in tax practice.

If the adviser "gives in" to such demands, not only is the advisers' own right to practice put in jeopardy, it's very possible that once the IRS becomes aware in examinations that the adviser is "flexible" in this manner that the agency might take an interest in other client's returns—thus risking examinations for clients who have not taken such aggressive positions, but nevertheless will still face the pain of an examination. Even a "no change" examination is a highly stressful event that most of your clients would prefer not to experience.

Section: 6662
Taxpayers with Reasonable Cause for Relying on Valuation Overstatement for 2004 and 2005 Cannot Claim Such Relief for Tax Due on Carryover of Unused Deduction to 2006 Due to Law Change

Citation: Reisner v. Commissioner, TC Memo 2014-230, 11/6/14

The case of *Reisner v. Commissioner*, TC Memo 2014-230 looked at a unique question—could the IRS use a revised version of the penalty rules first applicable to 2006 returns in determining whether a penalty could be waived for reasonable cause when the item giving rise to the penalty was related a carryforward from prior years when different rules applied.

In this case the issue related to the penalty under IRC §6662(h) which imposed a gross valuation misstatement penalty in certain cases. That provisions provides:

> (h) Increase in penalty in case of gross valuation misstatements
>
> (1) In general
>
> To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".
>
> (2) Gross valuation misstatements
>
> The term "gross valuation misstatements" means--
>
> (A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting--
>
> (i) in paragraph (1)(A), "200 percent" for "150 percent",
>
> (ii) in paragraph (1)(B)(i)--
>
> (I) "400 percent" for "200 percent", and
>
> (II) "25 percent" for "50 percent", and
>
> (iii) in paragraph (1)(B)(ii)--
>
> (I) "$20,000,000" for "$5,000,000", and
>
> (II) "20 percent" for "10 percent".
>
> (B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and
>
> (C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "40 percent" for "65 percent".

In this case the taxpayer conceded that that their claim of a deduction for a conservation easement triggered this penalty. Due to the size of the deduction claimed, the taxpayers exceeded their charitable deduction limits for 2004, and the excess carried over to both 2005 and 2006.

The penalties were abated for 2004 and 2005 by the IRS due to the taxpayers demonstrating reasonable cause. For those years, a demonstration of reasonable cause for the understatement pursuant to IRC §6664(c)(1) was sufficient to remove the penalty.

However, in 2006 the Congress amended IRC §6664(c), adding IRC §6664(c)(3) (actually (c)(2) at the time, but later renumbered to (c)(3)) which provided:

> (3) Special rule for certain valuation overstatements
>
> In the case of any underpayment attributable to a substantial or gross valuation overstatement under chapter 1 with respect to charitable deduction property, paragraph (1) shall not apply. The preceding sentence shall not apply to a substantial valuation overstatement under chapter 1 if--
>
> (A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and
>
> (B) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

This revision applied to returns filed after July 25, 2006.

The IRS argued that since the taxpayer's 2006 return was filed after that date, the penalty for 2006 could not be abated based on reasonable cause.

The taxpayers argued that such a result was inconsistent with Congress's intent. They pointed out that changes made at the same time to IRC §170(h)(4) (relating to conservation easements) applied to contributions made on or after July 25, 2006. The Court pointed that Congress did not apply such language in the statute, but rather clearly looked to a return filing date for the reasonable cause exception to the penalty.

As the Court noted, there had been a gross valuation misstatement in the prior years and the taxpayers had escaped the penalty due to the availability of a reasonable cause exception in those years. However for 2006 no such exception exists—thus, the penalty applied.

The Court also rejected the view that this was a "retroactive" penalty. The Court noted that the taxpayers reaffirmed the 2004 valuation when they filed a 2006 return claiming the benefit of that overstated valuation. Having taken that step after the law was changed, they now faced the consequences of claiming that tax benefit.

The taxpayers also pointed that the Court did not address reasonable cause in a similar case (*Pollard v. Commissioner*, T.C. Memo. 2013-38) that involved a contribution in a pre-2006 year and carryover into 2006. The Court noted:

> Our decision in *Pollard v. Commissioner*, T.C. Memo. 2013-38, does not contradict the conclusion we reach here (or our conclusion in Chandler). On brief in Pollard the Commissioner stated he would concede the gross valuation misstatement penalties for 2006 and 2007 if the taxpayer established that he satisfied the reasonable cause exception of section 6664(c)(2) for 2003, 2004, and 2005, which he did.

Or, to put it more simply, the Court was never asked to address the issue in *Pollard.* So while, based on the ruling in this case, the IRS could have prevailed and obtained the penalty for 2006 and 2007, it simply failed to ask to have the penalty applied.