Current Federal Tax Developments

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SECTION: 402
EXAMINING AGENT ABUSED DISCRETION BY REFUSING TO CONSIDER LATE ROLLOVER RELIEF REQUESTED BY TAXPAYER

Citation: Trimmer v. Commissioner, 148 TC No. 14, 4/20/17

The IRS claimed that prior to the publication of Rev. Proc. 2016-47 those involved in the examination of a taxpayer's return were barred from considering granting a waiver of the 60-day rollover period—the taxpayer had to have applied for a private letter ruling request for a waiver under Rev. Proc. 2003-16. The Tax Court, ruling in the case of *Trimmer v. Commissioner*,[1] 148 TC No. 14, did not find that the IRS was operating under any such restriction and ruled that the Tax Court had jurisdiction to consider whether the IRS had abused its discretion in refusing to grant such a waiver.

Mr. Trimmer suffered from major depressive disorder after a job he believed he had secured for himself to supplement his income after retiring from the New York Police Department fell through and he was unable to find substitute work. Shortly after he began suffering from the disorder he received distribution checks from his retirement account. He left the checks on his dresser at home for over a month and then deposited them into a regular, non-IRA bank account.

Mr. Trimmer did not make use of those funds while they in the non-IRA account. Due to his depression he delayed going to see his tax preparer until late in the following tax season. The preparer at that time discovered the Forms 1099R and he advised Mr. Trimmer to put those funds into an IRA account, which he did. The problem was that the 60-day period had long ago expired and the tax adviser did not suggest that Mr. Trimmer obtain an IRS private letter ruling to obtain IRS permission.

The IRS computers eventually noticed the problem and a CP2000 was issued to the taxpayer. The taxpayer wrote the IRS asking for relief:

> I am contesting the amount of money said to be owed. Please allow me to explain the situation. In April 2011 I retired from my job and took a pension loan. After my retirement I went through a period of depression and was not managing my affairs. I received my check for the loan and deposited it into Santander bank on July 5, 2011. The money remained in this account until April of 2012 when it was switched to an I.R.A. in the same bank where it remains to this day.
>
> A few points
>
> - There was no deception or spending, investing of the money at all. I received the check and deposited it into the bank
> - My wife and I have been paying taxes for a combined 60 years and NEVER had the least bit a problem.
> - There was no harm done to anyone with the money staying in the bank except me (I was receiving 0.25% interest.)
> - I switched the money to an I.R.A. before I was notified by the I.R.S.
>
> I am now employed again and am driving a school bus and have a son in college and another a year away. To pay $40,000 in taxes for money that is in an I.R.A. would absolutely cripple my family as it would be 3 years of my salary. Sir no harm was done to anyone. I went through a rough time upon separation from my job, causing me emotional hard times that caused this situation. Penalizing me and my family would not benefit anybody, only cause extreme duress and punish my children who played no part in this situation. I ask you to consider these facts and please come to a fair decision. Please contact me if you need at [phone number redacted].

[1] http://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11185

The IRS wrote Mr. Trimmer and told him "You don't need to do anything else for now. We will contact you again within 60 days to let you know what action we are taking." But three days later Mr. Trimmer received a letter from the operations manager denying his claim for relief, though the agency did invite Mr. Trimmer to write and tell them why he disagreed. Not surprisingly, Mr. Trimmer did not write again and outline his hardship.

The IRS issued the Notice of Deficiency and Mr. Trimmer filed his petition in Tax Court.

IRC §402(c)(3)(B) provides the following details of the IRS's authority to waive the 60-day rollover requirement:

> Hardship exception.--The Secretary may waive the 60-day require- ment under subparagraph (A) where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.

At time of Mr. Trimmer's letter to the IRS, the agency's guidance on this topic was found in Rev. Proc. 2003-16 which generally outlined how to apply, via a private letter ruling, to the agency for relief under the above rule. The IRS argued that, since Mr. Trimmer had not followed that revenue procedure, he did not qualify for relief.

In Rev. Proc. 2016-47, issued after the letter in question, the IRS did issue specific guidance on providing waivers during an exam. That document states:

> SECTION 4. ADDITIONAL WAIVERS DURING EXAM
>
> In addition to automatic waivers and waivers through application to the IRS under Section 3 of Rev. Proc. 2003-16, the IRS, in the course of examining a taxpayer's individual income tax return, may determine that the taxpayer qualifies for a waiver of the 60-day rollover requirement under § 402(c)(3)(B) or 408(d)(3)(I).

The Tax Court did not accept the IRS's view that the employee dealing with the exam could not have granted the waiver. The Court points out that the law itself provided no such constraint on the IRS's ability to grant relief. As well, while Rev. Proc. 2003-16 may not have specifically discussed granting relief during an exam, it did not indicate that the letter ruling was the sole method under which relief can be granted.

The Court noted the Internal Revenue Manual at 4.10.7.4(2) (Jan. 1. 2006) contains language that would appear to, by default, grant examining agents the right to consider all issues of the taxpayer:

> Examiners are given the authority to recommend the proper disposition of all identified issues, as well as any issues raised by the taxpayer.

The Court also dismissed the IRS's argument that the Court had no jurisdiction to look into the IRS's decision on the matter of granting relief. The Court noted the statute itself did not indicate that the decision was beyond review—rather the Court had the right to review the IRS's action to determine if it represented an abuse of authority.

As the Court noted, citing the case of *Estate of Gardner v. Commissioner,* 82 TC 1000, an automatic denial of the request without considering the facts and circumstances of the case, as took place here, would "constitute the very essence of arbitrary administrative action and an abuse of the discretion granted."

The Court concludes:

> In denying Mr. Trimmer's request for a hardship waiver, respondent's agent, proceeding on what appears to have been an incomplete understanding of the pertinent statutory provisions, failed to address or even acknowledge any of the facts and circumstances Mr. Trimmer set forth in his letter.

SECTION: 446
2017 REVISION OF COMPREHENSIVE LIST OF AUTOMATIC ACCOUNTING METHOD CHANGES ISSUED BY IRS

Citation: Revenue Procedure 2017-30, 4/19/17

In what now appears to be an annual event, the IRS has released a revised comprehensive list of accounting method changes in Rev. Proc. 2017-30.[2] The new ruling replaces Rev. Proc. 2016-29, issued approximately one year earlier.

The document is 337 pages long in the original PDF format published by the IRS. The significant changes section begins on page 325 and continues through to page 330 of the document. The new revenue procedure is effective for a Form 3115 filed on or after April 19, 2017 for a year of change ending on or after August 31, 2016.

The ruling also provides that if a taxpayer had been applying for a non-automatic change prior to the issuance of this ruling that now would qualify for automatic change treatment, the taxpayer may choose to use the automatic method by notifying the national office contact person of the intent to change to the automatic method by the later of:

- May 19, 2017 or
- The issuance of a letter ruling granting or denying the consent for change.

If the contact person is not known, the procedure refers the taxpayer to Section 9.08(6) of Rev. Proc. 2017-1.

A taxpayer converting to an automatic change must also take the following steps:

> A taxpayer converting a Form 3115 to the automatic change procedures in Rev. Proc. 2015-13 for a change in method of accounting described in this revenue procedure must resubmit a Form 3115 that conforms to the automatic change procedures, with a copy of the national office letter sent acknowledging the taxpayer's request attached, to the IRS in Covington, KY by the earlier of (a) the 30th calendar day after the date of the national office's letter acknowledging the taxpayer's request, or (b) the date the taxpayer is required to file the Duplicate copy of the Form 3115 under SECTION 6.03(1)(a)(i)(B) of Rev. Proc. 2015-13.

If a change no longer qualifies for automatic approval that did qualify previously, the following transition rules apply:

> (a) If before April 19, 2017, a taxpayer properly filed the original, or the Duplicate copy, of a Form 3115 under the automatic change procedures in Rev. Proc. 2015-13 for a change in method of accounting that can no longer be filed under the automatic change procedures in Rev. Proc. 2015-13, the taxpayer may make that change in method of accounting under the automatic change procedures in Rev. Proc. 2015-13 for the year of change.
>
> (b) If before April 19, 2017, a taxpayer did not properly file the original, or the Duplicate copy, of a Form 3115 under the automatic change procedures in Rev. Proc. 2015-13 for a change in method of accounting that can no longer be filed under the automatic change procedures in Rev. Proc. 2015-13, the taxpayer must make that change in method of accounting under the non-automatic change procedures in Rev. Proc. 2015-13. Notwithstanding § 1.446-1(e)(3)(i), the taxpayer may file a Form 3115 to request the Commissioner's consent to change the method of accounting under the non-automatic change procedures in Rev. Proc. 2015-13 for the taxpayer's last taxable year ending before April 19, 2017, on or before the due date of the federal income tax return for that taxable year. Solely for purposes

[2] https://www.irs.gov/pub/irs-drop/rp-17-30.pdf

of this paragraph (2)(b), the due date of the taxpayer's federal income tax return includes extensions, notwithstanding that the taxpayer may not have extended the due date.

SECTION: 469
TAXPAYER'S CLAIM OF WORKING NEARLY 13 HOURS EACH DAY FOUND NOT CREDIBLE, DENIED REAL ESTATE PROFESSIONAL STATUS

Citation: Penley v. Commissioner, TC Memo 2017-65, 4/17/17

While it is not impossible to qualify as a real estate professional under IRC §469(c)(7) if the taxpayer has a non-real estate full time job, it certainly is going to be difficult. The limited number of hours in the year created a credibility problem for the taxpayer in *Penley v. Commissioner*, TC Memo 2017-65, causing the Tax Court to find he had proven he qualified as a real estate professional.

In this case, the taxpayer had a full-time job that was described by the Court:

> During 2012 Mr. Penley was a full-time employee of HSS, Inc. (HSS). From January through September 2012 Mr. Penley worked as an entry-level field sterilization technician, and from October through December 2012 he worked as a sales account representative. Although Mr. Penley performed many of his duties from petitioners' home, he would travel to client sites as needed. These trips could take under half an hour in the case of a local client, or they could on occasion require him to travel several hours throughout Colorado. In all, Mr. Penley spent at least 2,194 hours, including occasional overtime, during 2012 performing his duties for HSS.

To qualify as a real estate professional under IRC §469(c)(7)(B) the taxpayer must meet the following two criteria:

- 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
- The 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 Mr. Penley's case, this meant that he had to show he spent at least 2,195 hours performing services in a real property trade or business to overcome the hours he spent working for his employer.

Before getting into the details of what records he could produce, it makes sense to first just consider how much work would be involved to meet this criterion. The minimum numbers hours Mr. Penley had to be working at his non-real estate job and on his real estate related activities had to be at least 4,389 hours (2195 + 2194).

Since 2012 was a leap year that meant there were 366 days on which Mr. Penley could perform that work. Assuming he worked every day of those 366 days, he would have need to average 11.99 hours per day—or, effectively, ½ of the time available in the entire year.

Mr. Penley claimed that, in fact, he spent 2,520 hours on his real estate activities, pushing his average now to nearly 13 hours per day.

The Tax Court had trouble buying the theory that Mr. Penley had achieved this super-work-a-holic status, finding:

> Petitioners' primary substantiation at trial for the hours Mr. Penley worked during 2012 was a monthly calendar. The calendar indicates the property where Mr. Penley worked on a particular day and contains a brief description of the work performed, an estimate of the number of hours worked, and the number of miles driven to and from the property.
>
> We find that this calendar greatly exaggerates the time Mr. Penley spent on his real estate activities. Generally Mr. Penley claims, for 2012, to have worked on his real estate activities 10-14 hours on each

> Saturday and Sunday during 2012 and an additional 4-6 hours most weekdays, in addition to another full-time job.
>
> … Virtually all of the entries are rounded to the nearest hour or half-hour, do not specify a start or end time for the work, include the time spent driving to and from the property, and do not separate out any time for meals or other breaks. See *Merino v. Commissioner*, T.C. Memo. 2013-167, at *8-*12; *Rapp v. Commissioner*, 78 T.C.M. (CCH) at 177-178 (discounting testimony that lacked specifics about time work was performed); *Pohoski v. Commissioner*, T.C. Memo. 1998-17, 75 T.C.M. (CCH) 1574, 1579 (1998) (noting that the large number of hours claimed seemed implausible, especially given that the calendar did not contain breaks for meals or leisure time with family). Corroborating evidence, such as credit card statements, phone bills, and emails relating to the purchase of Evergreen Park, demonstrates meaningful real estate activity by petitioners during 2012. However, petitioners have not provided the Court with a sufficient explanation to reconcile this documentary evidence of their activities such as a brief email, a phone call, or a hardware store purchase with the large blocks of time (often 4 hours to 14 hours) shown on the calendar. See *Hill v. Commissioner*, T.C. Memo. 2010-200, 100 T.C.M. (CCH) 220, 223 (2010) (finding that the excessive hours claimed by the taxpayer, relative to the tasks performed, diminished the credibility of the taxpayer's estimates), *aff'd*, 436 F. App'x 410 (5th Cir. 2011). We find that petitioners' calendar does not fall within the regulation's "any reasonable means". See sec. 1.469-5T(f)(4), Temporary Income Tax Regs., supra.

Thus, the Court found that Mr. Penley failed to qualify as a real estate professional.

SECTION: 1259
EXTENSION OF VARIABLE PREPAID FORWARD CONTRACTS DID NOT TRIGGER GAIN RECOGNITION

Citation: Estate of McKelvey v. Commissioner, 148 TC No. 13, 4/19/17

Rev. Rul. 2003-7 provides that variable prepaid futures contracts (VFPCs) represent "open transactions" that are not subject to tax until the contract is finally settled and do not represent constructive sales of the stock under IRC §1259. The case of *Estate of McKelvey v. Commissioner*,[3] 148 T.C. No. 13 looks at whether an extension of the VFPC represents either a taxable settlement of the contract or a constructive sale of the related shares under IRC §1259, a question not previously addressed by the Tax Court.

Under a variable prepaid forward contract, a taxpayer agrees to pledge a certain amount of stock in exchange for receiving a payment of cash. The contract provides that, at a specified date in the future the taxpayer will deliver either a number of shares of stock (either from the original pledged group or other shares the taxpayer has) or a cash payment. The number of shares to be delivered varies over a specified range of shares, based on the price of the stock on the date the transaction is closed. The shares that are pledged represent the maximum number that may need to be delivered. As well, the party pledging the shares would retain the right to close out the contract at any time before the final settlement date, either by transferring shares or cash.

Congress enacted IRC §1259 to deal with various transactions that had been used to defer gain on the sale of securities while still managing to reduce the taxpayer's exposure to price changes in the underlying asset. One of the types of transactions that would trigger immediate recognition was if a taxpayer entered into a futures or forward contract to deliver the same or substantially identical property. [IRC §1259(c)(1)(C)]

So, for instance, if a taxpayer received $200,000 today but agreed to deliver 500 shares of a corporation's stock to the other party in a year, the taxpayer would be treated as selling the shares upon entry into the contract, even though legal title to the shares would not pass until the following year. But a VFPC, as described above, does not meet the criteria found

[3] http://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11187

In Rev. Rul. 2003-7 the IRS ruled that such a VFPC was properly taxed under the "open transaction" doctrine. To qualify for treatment as an open transaction, the arrangement must meet the following criteria:

- The taxpayer receives a fixed amount of cash,
- The taxpayer simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date,
- The taxpayer pledges the maximum number of shares for which delivery could be required under the agreement,
- The taxpayer has the unrestricted legal right to deliver the pledged shares or to substitute cash or other shares for the pledged shares on the delivery date, and
- The taxpayer is not economically compelled to deliver the pledged shares

Under the open transaction doctrine, even though the taxpayer receives cash up front, no taxable gain or loss is recognized at that time. Rather, the gain or loss is calculated when the taxpayer closes out the transaction, as only then can the taxpayer's true basis be calculated since only then can it determined what exactly will be given to close out the transaction and the taxpayer's basis in such property.

There was no question in this case that the taxpayer had entered into a VFPC which met all the requirements of Rev. Rul. 2003-7. But as the originally scheduled settlement date approached, the taxpayer contacted the other parties to the transaction and negotiated, in exchange for paying a sum of cash, an extension of the contract, pushing the settlement date forward two years.

The IRS argued that the taxpayer had to recognize gain at the original due date of the initial VFPC. The agency argued that, first, the modification created a taxable exchange of the old contract for a new one and, second, that the modification was, unlike the VFPC itself, was subject to the gain recognition rules found in IRC §1259 for being a constructive sale of the underlying securities that would have been required to be transferred at the date the contract was modified.

The Tax Court ruled that the modification did not result in a taxable exchange because, under IRC §1001, the section governing taxation of sales or exchanges, there must be a sale or exchange of property. The Court found that the taxpayer did not possess any property at the time of the modification and thus could not have exchanged it. The Court noted that at the date the contract was entered into the taxpayer did receive property (cash) but immediately afterward all that remained as far as the taxpayer was concerned was an obligation to deliver cash or securities to close out the contract. That obligation did not represent property, thus there was nothing that could have been exchanged.

The Court also refused to accept the IRS's view that somehow this transaction took a transaction that had been exempt from the constructive sale rules of IRC §1259 and suddenly triggered the application of that section. While this provision clearly was meant to deal with specific situations where there was no sale or exchange technically under IRC §1001 and force gain to be recognized. But the Tax Court did not find that the IRS had shown in what manner this transaction triggered this Section.

The taxpayer modified an existing contract and the Court found that any analysis under IRC §1259 referred back to the original arrangement, which the IRS conceded was not taxable under IRC §1259.

As the opinion concludes:

> Respondent's argument that the extensions to the original VPFCs triggered constructive sales under section 1259 is predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs under section 1001. As we concluded above, the open transaction treatment afforded to the original VPFCs continued when decedent extended the settlement and averaging dates, and there was no exchange of property under section 1001. Accordingly, because respondent concedes that the original VPFCs were properly afforded open transaction treatment under section 1001 — and because the open transaction treatment continued when decedent executed the extensions — there is no merit to respondent's contention that the extended VPFCs should be viewed as separate and comprehensive financial instruments under section 1259.