Current Federal Tax Developments

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SECTION: SECURITY
LATEST PHISHING EMAIL TO TARGET TAX PROFESSIONALS USES SPOOFED EMAILS FROM EDUCATION PROVIDERS
Citation: IRS News Release IR-2017-111, 6/23/17

In the latest phishing scam aimed at tax professionals, the IRS warns that a fake email issued in the name of a professional education provider for preparers is making the rounds (*Security Summit Warns of New Phishing Email Targeting Tax Pros*, IR-2017-111).

Unfortunately, the internet's system for handing electronic mail was never designed with security in mind, and it is relatively trivial to "fake" a from address to make a message appear to come from a legitimate source. No access is needed to the systems or servers of the spoofed organization in order to pull off this fraud which makes it even more difficult to deal with. Also, it is also trivial to "borrow" graphics from legitimate web sites and to make the email look just like an actual email from the organization.

In this email, the firm/organization that provides professional education indicates there is a problem with the user's account and, in order to correct their account (and presumably allow the preparer to get credit for coursework) a large amount of personal and professional information is requested.

The IRS news release provides a copy of the email currently being used:

> *In our database, there is a failure, we need your information about your account.*
>
> *In addition, we need a photo of the driver's license, send all the data to the letter. Please do it as soon as possible, this will help us to revive the account.*
>
> **Company Name **
>
> **EServices Username **
>
> **EServices Password **
>
> **EServices Pin **
>
> **CAF number**
>
> **Answers to a secret question**
>
> **EIN Number **
>
> **Business Name*
>
> **Owner/Principal Name **
>
> **Owner/Principal DOB **
>
> **Owner/Principal SSN **
>
> **Prior Years AGI*
>
> *Mother's Maiden Name*

An education provider, be it a state CPA society, the AICPA, or a private provider (like Loscalzo Institute or our related organizations) has no need for the vast majority of the requested information.

However, as should be clear, such information would allow the party receiving it to masquerade as the professional, both for purposes of filing fraudulent returns and for more general identity theft actions against that individual.

As well, if any of the above information was actually needed to be provided to any organization (be it an education provider, a financial institution or other organization), prudence suggests a user should *never click a link provided in such an email* but rather log onto the entity's website by tying the organization's web address into the browser (such as http://www.loscalzo.com) and then check the account there.

If a professional has fallen victim to such a ruse, the IRS provides the following information:

> If you received or fell victim to the scam email, forward a copy to phishing@irs.gov. If you disclosed any credential information, contact the e-Services Help Desk to reset your password. If you disclosed information and taxpayer data was stolen, contact your local stakeholder liaison.

As well, in most states if personal information has been potentially exposed, state laws will require disclosure to all potentially affected individuals. That could include not just clients, but other individuals whose personal information might be found in client information (such as employees if the outsider potentially gained access to information found in W-2s prepared by the professional for the client). The professional also should take action to secure his/her own financial and other online accounts.

SECTION: 1362
CORPORATION'S ACTIVITIES AND COSTS RENDER RENTAL NOT §1362 PASSIVE INCOME
Citation: PLR 201725022, 6/23/17

If a S corporation has any accumulated earnings and profits, its S status is at risk due to "excess passive income" if it incurs such income for three straight years under IRC §1362(d)(3). While rentals can generate such passive income, a rental does not provide such passive income if it is deemed to be derived in the active trade or business of renting property (Reg. §1.1362-2(c)(5)(ii)(B)(2)). In PLR 201725022, the taxpayer asked the IRS to find that the rental income being received by a C corporation would not be treated as "passive income" if the corporation elected S status.

The corporation provided the rental involved significant services. The ruling notes:

> M is composed of a parcel of land situated on two contiguous lots. X acquired this parcel of land in Year1. At the time of acquisition, M was partially developed as a plaza containing N2 single-story buildings in a cottage complex along with a single two-story building, with a combined commercial office space of approximately N3 square feet. X later constructed another building to the cottage complex and a separate two-story building in M. With the addition of these two buildings, M had a combined commercial office space of approximately N4 square feet. In Year3, X finished construction of a new N5 square foot,

> tri-level building within M. All of the suite space comprising M is currently leased for use as medical offices and/or related services.
>
> X contracts with an independent leasing agent to assist in soliciting prospective tenants for M, negotiating leases and renewals, and overseeing post-leasing activities such as build-outs and renovations of suite space. X, with the assistance of the independent leasing agent, drafts, proposes, presents, and negotiates letters of intent to lease available suite spaces. Negotiation for leasing regularly requires the use of an independent space planner to design and tailor the spaces for prospective tenants. Once letters of intent are accepted, X, with the assistance of the independent leasing agent, prepares, finalizes, and executes the lease agreements with prospective tenants. Renewals of leases are similarly handled by X, which are often complicated by requests for concessions and renegotiation of the leasing rate. Renewals often require significant time and attention by X.
>
> X, through its employees, its agents, and the agents' employees, provides certain services in maintaining and repairing of the buildings, common areas, and grounds of M. X utilizes a standard lease agreement for its tenants, and under the lease agreements X has the obligation to provide certain services with respect to the leasing of space within M and to maintain or repair the following items: the heat and air conditioning systems, plumbing, hot water heaters, exterior lighting, signs, lawn care and gardening, roofs and exterior walls, exterior walkways, courtyards, parking areas, electricity, water and sewer, drainage, and garbage pickup.
>
> In addition, the following specific services are provided to M and its tenants by an employee or independent contractor/worker of X: daily walk-through inspections of M to report on water breaks, lighting outage, vandalism, damage to building exteriors and certain interior spaces; sweeping, cleaning and maintaining the common areas of M such as sideways, walkways, and parking lot; routine periodic inspection of building exteriors and interiors, including foundations, roofs, exterior lighting, grounds, and parking lot and engaging in maintenance and repairs as needed; treating the roofs of the buildings for moss growth yearly; recoating and resurfacing the parking lot; routine and periodic maintenance of the numerous heating and air conditioning units; renovating vacant suites for leasing; routine and periodic maintenance of the plumbing and sewer lines, and their repair and replacement as needed; maintenance, repair and replacement of exterior lighting and selected interior lighting; janitorial services for selected units and common areas; exterior window washing; regular maintenance of grounds and lawn care, and landscaping services when necessary; seasonal snow removal and ice control; weekly trash removal; periodic pest and vermin control; and emergency response and property access for public safety.

The IRS notes that, under Reg. §1.1362-2(c)(5)(ii)(B)(2), a rental would need to meet the following criteria to be deemed part of a trade or business of renting real estate:

> Rents received by a corporation are derived in the active trade or business of renting property only if, based on all of the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are

> not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all of the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

In this case the IRS ruled that the corporation's services and costs incurred were significant enough to treat the rental as derived in the active trade or business of leasing. Thus, the rental would not generate the S corporation §1362 style of "passive income."

One important item to note is that, even though the word "passive" is used in IRC §1362(d)(3), that definition is not the same as the one found at IRC §469 and the corporation was not asking for a finding that any income or loss would not be required to be treated as passive under §469 by any of the shareholders. This is one of many unfortunate cases where Congress uses the same word to have different and, at times contradictory, meanings in different provisions of the law.

SECTION: 3401
CORPORATION LIABLE FOR PAYROLL TAXES LEFT UNPAID BY PEO
Citation: Chief Counsel Advice 201724025. 6/16/17

When an employer decides to use a third party from which to lease employees, the employer does not escape liability for the payroll taxes if they remain unpaid even if the employer makes the payment. This was the issue the IRS was looking at in Chief Counsel Advice 201724025.

In this case the taxpayer had hired an outside professional employer organization (PEO) to manage its payroll. Although the company had paid the PEO for the payroll and the amount that was due on the payroll taxes, the PEO failed to pay the payroll taxes. The corporation discovered this fact on exam.

The corporation did not dispute that it was the common law employer of the individuals in question—it had the right to direct and control "all aspects of the employment relationship between itself and these individuals."

The corporation had not filed any payroll tax reports, as that was the responsibility of the PEO under its agreement, nor had it verified that payroll tax deposits were begin timely made. While the common law employer generally has the ultimate responsibility for the payroll tax payments, this corporation argued that in this case IRC §3401(d) shifts the responsibility to the PEO.

That provision provides:

> (d) Employer
>
> For purposes of this chapter, the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—
>
> > (1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer"

> (except for purposes of subsection (a)) means the person having control of the payment of such wages…

The corporation's position was that the PEO was the "person having control of the payment of such wages" in this case.

The memo looked at many cases that applied this provision. The memo notes that, per the applicable regulations, the key issue is which entity had "legal control" of the payment of wages.

First the memo looked at a case where someone other than the common law employer had control of the payment of wages:

> In *Winstead v. United States*, 109 F.2d 989 (4th Cir. 1997), the taxpayer, Winstead, owned land that was farmed by sharecroppers, who were accountable for their hired help. However, the sharecroppers could not pay the hired help until after the crops were sold. Therefore, Winstead paid the help from his checking account, over which the sharecroppers had no authority, then deducted what he paid from the sharecroppers' share of the crop proceeds. Winstead, who was not the common law employer, was held to have control of the payment of wages to the hired help and thus to be the employer under section 3401(d)(1).

However, the IRS then goes on to look at an employee leasing arrangement case and notes that the Court there found that the common law employer retained control of the payment of wages:

> In *In re Earthmovers, Inc.*, 199 B.R. 62 (Bankr. M.D. Fla. 1996), the taxpayer, Earthmovers, a construction company in Chapter 11 bankruptcy, contracted with a leasing company that operated similarly to the PEO in this case. Pursuant to the terms of the contract, Earthmovers leased all of its employees from Sunshine Staff Leasing. The employees were under the direction and control of Earthmovers, but Sunshine was responsible for the payment of wages to the employees, the collection of the appropriate payroll taxes from the paychecks, the payment of all employee withholding taxes due, and the filing of all necessary Federal tax forms. Because Earthmovers had exclusive control of its workers, the court held it to be the common law employer. The court also found that because Earthmovers submitted the information regarding the hours worked each week by each employee, forwarded the amount owed for payroll (including the tax amounts) to Sunshine, and retained the right to hire and fire the employees, Sunshine was not in control of the payment of wages for purposes of section 3401(d)(1). Thus, the court held, Earthmovers bore ultimate responsibility for payment of taxes.

Thus, the IRS concludes:

> Based on the provisions contained in the contract, the PEO is not considered to be in control of the payment of wages within the meaning of section 3401(d)(1) because the PEO did not assume legal responsibility for payment of the wages to the employees. Under the terms of the contract, Taxpayer must pay the PEO an amount equal to the wages and salaries with respect to the workers in advance of the next payroll date. To ensure that the PEO will not be responsible for payment of wages to these workers, Taxpayer must provide a security deposit or letter of credit naming the PEO as beneficiary in the amount as determined by the

> PEO to cover the wages and salaries. Additionally, the PEO may terminate the contract immediately without notice and Taxpayer is "responsible for payment of all wages, salaries and employment related taxes."
>
> Thus, the PEO acted merely as a conduit for Taxpayer in making payroll and does not meet the standards in section 3401(d)(1) and the regulations thereunder.

Results such as these are the reason why Congress added a "Certified PEO" provision to the law, allowing an employer to enter into arrangements with certain PEOs that obtain IRS certification where the liability does shift to the PEO. Although the rollout of the program moved slower than the law indicated it would, eventually an employer can make use of a CPEO to insure the company does not pay the same payroll taxes twice.

Until then, or if the PEO the taxpayer wants to use does not obtain certification, the taxpayer can best protect itself by checking the payroll tax transcripts regularly to ensure that the taxes are being paid.

SECTION: 6109
IRS BEGINS ISSUING PTINS WITHOUT CHARGE, BUT RESERVES RIGHT TO CHARGE LATER
Citation: IRS Reopening Preparer Tax Identification Number (PTIN) System, IRS Website, 6/21/17

The IRS has begun again issuing PTINs after suspending such issuance immediately losing the ability to charge fees for PTINs in the case of *Steele, et al v. United States*, (US DC District of Columbia). The announcement, along with a series of Q&As on the issue, was posted to the IRS website ("*IRS Reopening Preparer Tax Identification Number (PTIN) System*").

The IRS is charging for a PTIN issuance at this time, but the Q&As reserve the possibility that those receiving a "free" PTIN at this time might be required to pay for it later.

The Q&As are reproduced below:

> Q: Are federal tax return preparers still required to have a PTIN?
>
> A: Yes. The court decision upheld the IRS' authority to require the use of a PTIN. Anyone who prepares, or assists in preparing, all or substantially all of a federal tax return for compensation is required to have a PTIN. All enrolled agents must also have a valid PTIN.
>
> Q: Will PTIN holders be receiving refunds for previous fees paid?
>
> A: The IRS, working with the Department of Justice, is considering how to proceed. As additional information becomes available, it will be posted on our Tax Pros page.
>
> Q: If I obtain or renew my PTIN now at no cost, will I have to pay for it later?
>
> A: We can make no determinations with respect to future activity at this time.
>
> Q: Is the PTIN Helpline reopening?
>
> A: Yes. It will also reopen on June 21, 2017.

Q: Is a PTIN still required to file a tax return, to be an Enrolled Agent or schedule an appointment for the Special Enrollment Examination

A: Yes.

Q: Will I be able to view my continuing education records when the PTIN system reopens?

A: Yes. All previous information will still be displayed in online PTIN accounts.

Q: Do I need to contact the IRS or file a claim for refund for previously paid PTIN fees?

A: Do not contact the IRS. Any questions regarding claims or refunds should be directed to the PTIN Fees Class Action Administrator at www.ptinclassaction.com.

SECTION: 7122
IRS ADDITION OF PAYROLL TAX LIABILITY THAT WAS SUBJECT OF OIC TO GOING CONCERN VALUE OF BUSINESS WAS NOT REASONABLE
Citation: W. Zintl Construction, Inc. v. Commissioner, TC Memo 2017-119, 6/19/17

In the case of *W. Zintl Construction, Inc. v. Commissioner*, TC Memo 2017-119 the taxpayer in question was a corporation with a rather significant unpaid payroll tax liability ($6,563,263 to be exact). The corporation was seeking an offer in compromise with regard to these taxes. The IRS settlement officer (SO) determined that the offer was not to be accepted. In doing so he considered the going concern value of the business as a whole and then added back the underlying payroll tax liability.

The taxpayer took its case to the Tax Court, arguing that a going concern value should not be used against the business itself, as opposed to that of the owner of the business. The Tax Court disagreed with this view, but also determined the settlement officer had improperly computed the going concern value when he added back to that value the payroll tax liability.

The taxpayer had originally made an offer of $1 million to settle the case, with its justification explained as follows:

> On a Form 656, Offer in Compromise, submitted on August 27, 2013, petitioner made an OIC of $1 million. In support thereof petitioner provided a profit and loss statement and a balance sheet ending June 30, 2013, and a Summary Appraisal Report by Hoff Appraisal Associates dated February 12, 2013, indicating a "Forced Liquidation Value" for petitioner's machinery and equipment of $1,155,000. In an accompanying letter to Settlement Officer (SO) Albright, petitioner indicated an accounts receivable balance of $3,359,920 as of August 9, 2013. After quoting the Internal Revenue Manual (IRM) regarding the proper treatment of accounts receivable, the letter explained that "Zintl is profitable and its receivables are part of the income stream required for the production of income. The company must pay for materials and labor to continue operating. Without the income flow from these receivables the business could not operate." Petitioner also explained that "[t]he liquidation of Zintl's inventory, machinery, and equipment would end its ability to operate. Zintl recently sold all of the assets it could spare to satisfy an obligation to Citizens State Bank that was secured by its inventory and equipment."

The SO requested additional documents including a valuation of the business as a going concern.

> Petitioner sent the documents requested, including a going-concern appraisal prepared by Shenehon Co. dated April 16, 2014. The going-concern appraisal estimated a going-concern fair market value of $2,100,000, using three valuation methods, each of which subtracted accrued payroll tax liability and interest of $4,190,290. The largest [*5] single asset reflected in the appraisal was the accounts receivable (in excess of $7 million at the end of petitioner's fiscal year ending January 20143), and the largest single liability was the payroll tax liability. The appraisal did not include the accumulated penalties on the tax liability (estimated to be $2,101,723). The appraisal assigned no value to goodwill. The appraisal also estimated a liquidation value for the company of negative $3,720,000.

As an offer in compromise must be for at the reasonable collection potential, the SO made a determination of that reasonable collection potential. He communicated that information to the taxpayer in a letter which stated:

> [The] appraisal estimated the value of the business to be $2,100,000 after allowing for the IRS debt of $4,190,980. In other words the value of the business for purposes of the OIC is estimated to be $6,290,980. In determining the reasonable collection potential in an OIC, the IRS would generally reduce the asset values by 20%. As a result, in this case the reasonable collection potential is computed to be $5,032,784 ($6,290,890 x.8).

The SO indicated that the taxpayer needed to submit an amended offer at least equal to the computed reasonable collection potential and that, if it did not do so, he would likely reject the $1 million offer. The taxapayer's response was to protest that the going concern value should not be considered and kept its offer at $1 million. The SO rejected the offer as being too low.

The Tax Court noted that consideration of the going concern value is provided for in the Internal Revenue Manual and found that the use of the method itself was not a problem. But the Court had an issue with the agent adding to that value the payroll tax liability that was used to compute the value.

The Court understand why the SO felt the need to add back the payroll tax liability, but found it was not justified:

> This modification to the value at first blush seems logical. Reducing petitioner's going-concern value by its tax liability when determining how much of this tax liability petitioner can pay would seem to double count the tax liability and provide a boon to a business taxpayer whose tax debt is part of the business being valued. It is this tax liability that will be satisfied with the OIC, after all. The problem is that the going-concern value is intended to give some indication of [*12] the value of petitioner as a continuing business, that is, what a third party might pay to buy petitioner as a whole, including all of its assets and liabilities. No third party would buy petitioner without taking into account the unpaid tax liability. And the record shows that petitioner could not obtain financing for the modified amount either. This highlights the logical difficulty of using going-concern value — which presumes that a taxpayer can sell itself — to determine RCP. Nonetheless, we cannot conclude that

consideration of the going-concern value and the information in the appraisal is irrelevant or that the settlement officer may not consider this information, including the specific assets and liabilities, including the tax liability, on remand. We also do not hold that petitioner's offer was reasonable. We hold only that SO Albright's rejection of petitioner's OIC solely on the basis of his calculation of RCP that used petitioner's going-concern valuation but disregarded completely its tax liability was not reasonable on this record.