Current Federal Tax Developments

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SECTION: 72
EMPLOYER'S FAILURE TO DEDUCT 401(K) LOAN PAYMENTS FROM EMPLOYEE'S PAY WHILE ON LEAVE RESULTED IN TAXABLE DISTRIBUTION

Citation: Frias v. Commissioner, TC Memo 2017-139, 7/11/17

A participant in a qualified employer retirement plan may, if the plan allows it, borrow funds from the plan. However, such borrowing is subject to a number of specific provisions in federal law and regulations. Violation of the provisions regarding repaying the loan results in its treatment as a distribution from the plan, taxable to the participant. That's true even though the participant remains liable to repay and does actually repay the loan to the plan.

In the case of *Frias v. Commissioner*, TC Memo 2017-139 there was little question the written terms of the loan had not been followed—but the failure had been due to a failure by the employer to fulfill its obligation to withhold the payment from Ms. Frias's checks she received while was on maternity leave.

Ms. Frias was a participant in Glen Island's 401(k) plan. Ms. Frias was getting ready to go on maternity leave and on July 27, 2012 borrowed $40,000 from the plan. The loan provided that Glen Island would withhold the payment amounts from Ms. Frias's biweekly paychecks, with the first payment to be taken from her August 10, 2012 paycheck. The amount of each payment was to be $341.79. Under the terms of the loan, should Ms. Frias end up in default for such a payment, she could correct the shortfall by the end of the month following the month in which the default occurred.

Glen Island's 401(k) plan was being administered by Mutual of America Life Insurance Company. Any payments Glen Island were to withhold from Ms. Frias's pay were to be forwarded to Mutual of America to apply against the loan. Mutual of America was also responsible each year for preparation of any required Forms 1099R for the plan.

Ms. Frias began her maternity leave three days after the loan was taken out. During her leave of absence Ms. Frias continued to receive some paychecks based on her sick and vacation time. However, her employer mistakenly failed to withhold the required payments on her 401(k) plan loan from these checks. Ms. Frias returned to work on October 12, 2012.

After she returned to work she was informed by her employer that they had neglected to deduct the payments from any of the checks she received while on leave, thus putting her in violation of the loan agreement.

Upon learning of this error, Ms. Frias made a payment of $1,000 on November 20, 2012. She also instructed her employer to increase the payments they were withholding from her paycheck to $500 per pay period through July 15, 2013. After that date, the payments reverted to the original amount, with all payments being made until the loan had been fully repaid in July of 2014.

However, the Tax Court noted that while all may appear well, the regulations under IRC §72(p) created a problem in this situation:

> Although a loan originally may satisfy the section 72(p) requirements, "a deemed distribution occurs at the first time that the requirements * * * of this section are not satisfied, in form or in operation." Sec. 1.72(p)-1, Q&A-4(a), Income Tax Regs. If "payments are not made in accordance with the terms applicable to the loan, a deemed distribution occurs as a result of the failure to make such payments." Id.; see *Duncan v. Commissioner*, T.C. Memo. 2005-171; *Molina v. Commissioner*, T.C. Memo. 2004-258. The plan administrator may provide the participant with an opportunity to cure the failure, and a deemed distribution does not occur unless the participant fails to pay the delinquent payment within the cure period. Sec. 1.72(p)-1, Q&A-10(a), Income Tax Regs.; see *Owusu v. Commissioner*, T.C. Memo. 2010-186.

While Ms. Frias may not have been aware of this law provision, the plan administrator was not only aware of it but issued a 2012 Form 1099R to Ms. Frias. However, the Form 1099R was delivered online (that is, not sent by mail) and Ms. Frias, although she had access to the website where the Form 1099R was uploaded, did not access or review it. The Court also noted that the record before the Court did not disclose whether Ms. Frias was given notice that a Form 1099R had been issued. In any event, Ms. Frias clearly did not believe that any distribution or other taxable event had taken place until the IRS came calling—and that belief is clearly a reasonable one for anyone who doesn't have a detailed understanding of the qualified plan loan provisions in the law and regulations.

The IRS position was that a distribution took place because Ms. Frias violated the terms of the loan on August 24, 2012 when the first payment due was not made and then did not correct the violation by September 30, 2012, the last date allowed for her to make such a corrective payment under the terms of the plan loan.

The taxpayer argued that she was not actually in violation because, at the time the first payment was due, she was on a leave of absence without pay, which under Reg. §1.72(p)-1, Q&A-9(a), would exempt her from the substantially equal repayment requirements required for such plan loans. That portion of the regulation provides:

> Q-9: Does the level amortization requirement of section 72(p)(2)(C) apply when a participant is on a leave of absence without pay?
>
> A-9: (a)Leave of absence. The level amortization requirement of section 72(p)(2)(C) does not apply for a period, not longer than one year (or such longer period as may apply under section 414(u) and paragraph (b) of this Q&A-9), that a participant is on a bona fide leave of absence, either without pay from the employer or at a rate of pay (after applicable employment tax withholdings) that is less than the amount of the installment payments required under the terms of the loan. However, the loan (including interest that accrues during the leave of absence) must be repaid by the latest permissible term of the loan and the amount of the installments due after the leave ends must not be less than the amount required under the terms of the original loan.

The opinion noted that there was one problem—Ms. Frias did receive some paychecks during that period, using up her accrued sick and vacation time, and certainly the check from which the August 24, 2012 would have been withheld was well in excess of the amount of the payment due. The Court rejected Ms. Frias' assertion that such payments were not actually wages, finding that the unpublished Federal District Court memorandum and order cited by her dealt only with the calculation of "wages" for Social Security benefits, not with "pay" under the above regulation.

Ms. Frias contended that, regardless, that the use of accrued sick, personal and vacation time should not count as "pay" because the Family and Medical Leave Act of 1993 allows an employee who is on unpaid leave to use such accrued days as all or part of FMLA leave—and her maternity leave would have qualified as FMLA leave. The Court rejected this view, noting:

> The right of an employee during FMLA leave to receive payments for leave earned by the employee does not excuse Mrs. Frias' failure to make loan payments from compensation she received during the first five weeks of her leave. Even if we were to accept petitioners' argument about the FMLA, which we do not, the record is devoid of any evidence that Mrs. Frias was actually on or qualified for FMLA leave. Petitioners have failed to convince us that the FMLA excused petitioners from the substantially level amortization requirement of section 72(p)(2)(C).

But what about the fact that her employer and the plan administrator acted as if the problem had been corrected? After all, given that Ms. Frias really was, in many ways, a victim of the failure of her employer to fulfill its obligation shouldn't there be some relief.

Specifically, the Court noted she advanced three theories:

> Petitioners also contend that if section 1.72(p)-1, Income Tax Regs., does not apply, there was no distribution because: (1) all parties to the loan acted as though they agreed to suspend payments; (2) the substance of the repayments should be honored over the form that was required; or (3) Mrs. Frias corrected the default in accordance with Rev. Proc. 2008-50, 2008-2 C.B. (Vol. 1) 464, 481.

The Court held that if, in fact, there had been an agreement among the parties to modify the loan, the loan agreement needed to be amended in writing to stay compliant with the regulations. There was no evidence that such a written amendment was ever made.

The opinion also held that the loan document and the regulations do allow for a "substance over form" treatment of this transaction—Ms. Frias, as a party to the agreement, needed to follow the form that she had agreed to.

Finally, the Court noted that Rev. Proc. 2008-2 allows for a *plan sponsor*, not a participant, to request relief from the IRS to correct plan loans that do comply with IRC §72(p)(2). There was no evidence that Glen Island had made such a request. The revenue procedure does offer an opportunity for a plan participant to seek such relief where the plan sponsor did not seek such relief.

The case is instructive regarding the risks involved both for participants who take out such loans and for plan sponsors who have plans that allow such loans to be taken. Certainly, it would seem

reasonable to believe that Ms. Frias is, at a minimum, somewhat upset with her employer since it was the sponsor's mistake that started the process that lead to Ms. Frias owning over $15,000 in tax on funds that she had fully repaid to the plan.

SECTION: 162
LEGAL FEES RELATED TO EMPLOYMENT, NOT TAXPAYER'S NEW BUSINESS VENTURE

Citation: Dulik v. Commissioner, TC Summ. Op. 2017-51, 7/14/17

Whether a taxpayer can claim a deduction for legal expenses generally depends on the origin of the claim giving rise to the legal expense. This means that even if the legal expense might arguably have an impact on one activity (say, a new trade or business the taxpayer is establishing) it will not be deductible as part of that activity if the claim originated elsewhere. The case of *Dulik v. Commissioner*, TC Summ. Op. 2017-51 deals with this issue.

In this case the taxpayer was negotiating a separation agreement from his former employer. In doing so he paid $26,781 in legal fees related to various issues in negotiating that agreement, specifically looking to get removed from the agreement a reference to a secrecy agreement he had signed with a predecessor of his current employer which contained a non-compete agreement.

The deduction was claimed on the tax return for an S corporation he had formed to start performing consulting services. The IRS, while agreeing that the legal fees are deductible, took the position that the expenses were those of Mr. Dulik personally and that, rather than being deducted in computing adjusted gross income as part of an S corporation loss, they are only deductible as miscellaneous itemized deductions.

Per the Court, the taxpayer's position was as follows:

> Petitioners assert that after Nycomed terminated Mr. Dulik's employment he was "pursuing his business" and seeking to work as an independent contractor consulting for the pharmaceutical industry; but because of the noncompete covenant of the secrecy agreement, no one would hire him. Mr. Dulik testified that he signed the severance agreement because he would have had to forgo his severance pay if he had not signed it. Mr. Dulik also testified that he did not incorporate AED until September 2010 because "[o]riginally when I started the business it was going to be a Schedule C proprietorship * * * later in 2010 I formed a subchapter S corporation fearing * * * legal issues could arise out of some of my activities."
>
> Petitioners do not assert that the claim against Nycomed was rooted in Mr. Dulik's consulting business; instead they contend that the origin of the claim is Nycomed's restriction on Mr. Dulik's ability to work. Petitioners assert that Mr. Dulik hired counsel solely to renegotiate the terms of the severance agreement, so that he could operate a business as a consultant in the pharmaceutical industry. Mr. Dulik testified that but for his desire to work in the pharmaceutical industry he would have not hired counsel; for example, if he had wanted to work as a C.P.A. for an accounting firm, he would not have tried to negotiate the terms of the severance agreement.

The Tax Court did not find Mr. Dulik's position to be correct. Rather, the Court held:

> Although the terms of the severance agreement may have prevented Mr. Dulik from operating a consulting business in the pharmaceutical industry, we look to the origin of the claim, not to the potential consequences of a win or loss in negotiating the terms of the severance agreement. Mr. Dulik's claim arose from his status as a former employee of Nycomed, not from his consulting business. He hired attorneys because he was trying to negotiate the terms of the severance agreement proffered in connection with the termination of his employment at Nycomed. See *Gilmore*, 372 U.S. at 49; *Kenton v. Commissioner*, 2006 WL 237112, at *2-*3; *Test v. Commissioner*, 2000 WL 1738858, at *4. We conclude that petitioners are not permitted to deduct the legal fees as ordinary and necessary business expenses of Mr. Dulik's consulting business as a flowthrough from AED. However, petitioners are entitled to $26,3256 as a miscellaneous itemized deduction on Schedule A, subject to the limitations set forth supra. See secs. 56(b)(1)(A)(i), 67(a) and (b), 68, 211, 212(1).

SECTION: 468
ELECTION TO CURRENTLY DEDUCT FUTURE LANDFILL CLEANUP COSTS UNDER §468 NOT LIMITED TO ACCRUAL BASIS TAXPAYERS

Citation: Gregory v. Commissioner, 149 TC No. 2, 7/11/17

IRC §468 allows electing taxpayers who, among other things, operate landfills to claim a current deduction for costs that will be incurred once the landfill is closed to clean up the site. But the IRS argued in the case of *Gregory v. Commissioner*, 149 TC No. 2 that this election was restricted to taxpayers who used the overall accrual method of accounting for tax purposes.

IRC §448's language allows a deduction to a *taxpayer* who elects the application of the provision. The taxpayers argued that nowhere in the statute did Congress restrict the taxpayers who could make this election to those using the overall accrual basis of accounting and that, based on the plain language of the statute, they should be allowed to take a deduction for such future clean-up costs regardless of the fact they reported their income and deductions generally on the cash basis of accounting.

The parties agreed about much—there was no dispute about the amount of the deduction if the taxpayers were qualified to elect under §468, no question that they were properly on the cash basis of accounting, and no question that they filed the required election. As well, the taxpayers agreed that if the statute truly was limited to those on accrual basis of accounting that they would be denied the deduction.

The Tax Court therefore was stuck with deciding what the term "taxpayer" in IRC §468(a) referred to. The Court notes that if the words of the statute are clear an unambiguous, then no additional sources need to be consulted, with court noting "[w]e assume the statute was written as Congress intended."

The Tax Court notes that while §468 itself does not have a definition of taxpayer, the IRC itself has definitions that apply in the absence of being overridden by the specific section that is found at IRC

§7701. IRC §7701(a)(14) provides that "[t]he term taxpayer means any person subject to an internal revenue tax." In this case the electing entity was an S corporation, which itself is not subject to income tax. But, as the opinion notes, S corporations are subject to Social Security and unemployment taxes, which are also internal revenue taxes.

Now the Court went searching to see if this definition was somehow overridden by IRC §468. The Court found there was no such contrary rule found anywhere within IRC §448. And, the Court found, nothing in the section was "manifestly incompatible" with applying the standard IRC §7701 definition of taxpayer to §448. The opinion notes that in numerous cases Congress had expressly applied the limitation of "on the accrual basis" to the term taxpayer in provisions that it wished to limit to taxpayers using the accrual basis of accounting.

The Court notes that having found that the statute was unambiguous the issue is decided, but it did comment on a series of arguments the IRS attempted to bring forward to argue and rejected each of them. Those arguments included:

- The argument that §468 was not included in the list of expenses a cash basis taxpayer can deduct even if not paid found in Reg. §1.461-1(a)(1)—but the Court points out that the list is prefaced by "such as" making clear that the list does not represent an exhaustive list of such deductions.
- That the statute uses the term "incurred" which implies accrual, while Congress uses the term "paid" when discussing cash basis accounting. But the Court points out that while §448 at points uses the term "incurred" it also at points uses the cash basis term "paid" so this doesn't prove anything.
- The Court rejected the IRS argument that §468 "must be ambiguous" if the Court needs to go to §7701 to find the definition of taxpayer. As the Court notes, §7701 adds clarity, not ambiguity, to the IRC.
- Finally, the Court dismissed the Blue Book, noting that such books are compiled *after* Congress enacts the law and thus did not inform the decisions of the members of Congress who voted for the law.

The key take-away from this case is a reminder that unambiguous law text renders other sources irrelevant. And, as the Court points out, only in very limited circumstances will be the Court even consider looking at legislative history—and when a Court does feel it must go there it does "so with caution."

SECTION: 6413
IRS EMAIL EXPLAINS LIMITS TO USE OF FORM 941-X FOR PRIOR YEAR ERRORS IN FEDERAL INCOME TAX WITHHOLDING

Citation: Chief Counsel Email 201727008, 7/7/17

In emailed advice (Chief Counsel Email 201727008), the IRS Chief Counsel's office discussed the limitation on the use of Form 941-X, specifically looking at what qualifies as "administrative error"

for which the Form 941-X can be used to address issues on prior year's payroll tax reports related to federal income tax withheld.

People do make mistakes, and at time those errors involve payroll tax issues, including tax withholding. Form 941-X was created to allow employers to deal with some errors—but the form has very specific limitations on its use. As a practical matter, once a year has ended and the employee has been given a W-2, the consequences of, say, overwithholding or underwitholding federal income taxes gets "passed on" to the employee since that number is claimed as a credit on the employee's own income tax return.

The instructions for Form 941-X provide the following limitation on the use of the form regarding federal income taxes withheld, specifically when the matter concerns such taxes reported on a Form 941 for an earlier year:

> *Generally, you may correct federal income tax withholding errors only if you discovered the errors in the same calendar year you paid the wages. In addition, for an overcollection, you may correct federal income tax withholding only if you also repaid or reimbursed the employees in the same year. For prior years, you may only correct administrative errors to federal income tax withholding (that is, errors in which the amount reported on Form 941, line 3, doesn't agree with the amount you withheld from an employee's wages) and errors for which section 3509 rates apply.*

The email responds to a request for guidance in processing Forms 941-X where employers are claiming "administrative error" on federal income tax withholding and asking for a refund of overpaid taxes. Employers filing Form 941-X are filing the form, claiming an "administrative error" as the justification for filing the form.

> Employers are using Form 941-X to correct federal income tax withheld from an employee in a prior year after an employer discovers that it didn't withhold the right amount — including because employer incorrectly calculated the amount of federal income tax it paid in a prior year on behalf of the employee, rather than deducting it from the employee's pay (which resulted in additional wages subject to tax).

The emailed advice agrees with the conclusion of the IRS employee requesting guidance that such items are not "administrative errors" as defined in the instructions. As the email states:

> …[O]nly transposition or basic math errors, such as addition-subtraction and multiplication computations, in which the amount reported on Form 941, line 3 (Federal income tax withheld from wages, tips, and other compensation), doesn't agree with the amount you withheld from an employee's wages are administrative errors.
>
> Generally, an employer may correct non-administrative errors for federal income tax withholding on an adjusted employment tax return only if the errors are discovered in the same calendar year employer paid the wages. Moreover, for an overcollection, an employer may correct federal income tax withholding only if the employer also repaid or reimbursed the employees in the same year.

The email goes on to note that other prior year errors are not subject to such corrections.

> For prior years, an employer may correct federal income tax withholding errors ONLY if they are administrative errors.
>
> If in a subsequent year an employer determines that it incorrectly calculated the amount of tax it withheld in the prior year, the employer can't correct the federal income tax withholding. The amount of Federal income tax withheld, shown in Box 2 on Form W-2, Wage and Tax Statement, is used by the employee to claim a credit for withholding for individual income tax return purposes.

The email goes on to provide some examples of what does not constitute administrative error for which a Form 941-X can be filed:

> Here are a few specific examples of non-administrative errors. If in a subsequent year an employer determines that it incorrectly calculated the amount of tax it withheld in the prior year, the employer can't correct the federal income tax withholding just because the employer happened to have:
>
> - used the wrong income tax withholding table in Pub. 15 or
> - didn't treat a payment correctly as taxable or nontaxable or
> - paid federal income tax on behalf of the employee, rather than deducting it from the employee's pay (which resulted in additional wages subject to tax).
>
> See § 31.6413(a)-1, § 31.6413(a)-2, and Rev. Rul. 2009-39, 2009-52, I.R.B. 951 at www.irs.gov/irb/2009-52_IRB/ar14.html.