Current Federal Tax Developments

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SECTION: CIRCULAR 230
CHANGE OF HEART BY HUSBAND RESULTED IN CONFLICT OF INTEREST FOR REPRESENTATIVE

Citation: Gebman v. Commissioner, TC Memo 2017-184, 9/18/17

Representing a married couple always brings with it the risk that the interests of the two parties won't be in alignment, creating a conflict of interest issue. That may be true even when the adviser reasonably concludes that both spouses agree to a course of action, that initial "waiver" of the conflict does not serve to ensure that the same conflict won't again become a problem in the engagement.

The case of *Gebman v. Commissioner,* TC Memo 2017-184 deals with issues that arose for an attorney representing a client before the Tax Court, but similar issues and problems can arise for CPAs well before a tax dispute ends up in court, so a review of what happened in this case is useful for all practitioners.

The situation began when the attorney in question decided to do something good and offer up his services for free to Tax Court litigants who arrived at Court without representation under a program operated by the New York County Lawyers' Association. Mr. Gebman was offered the opportunity by the Court to speak with a volunteer lawyer before his case was heard that afternoon and Mr. Gebman took advantage of the opportunity.

The attorney was not terribly impressed with the taxpayer's case. As the Court noted:

> …[W]ith respect to petitioners' assignments of error, he told Mr. Gebman during their January 30 meeting that petitioners' assignments were frivolous (i.e., in Mr. Agostino's words: "not well grounded in fact or warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law"). See Goff v. Commissioner, 135 T.C. 231, 237 (2010) (similarly defining "frivolous"); Model Rule 3.1 (similar). He told Mr. Gebman that prosecution of his claims could "(a) result in the imposition of sanctions pursuant to IRC sec. 6673; and (b) have collateral consequences to Mrs. Gebman." He also told him that he would not represent him in challenging the notice of deficiency or in asking the Court to reconsider its [*11] denial of his request for a continuance. He did, however, offer "to represent Mr. Gebman, and/or supervise the representation of Mr. Gebman, with respect to the prosecution of the post-assessment collection alternatives available to him under IRC sec. 6330" ("Notice and Opportunity for Hearing Before Levy."). He states that, shortly before recall of the case, "Mr. Gebman told me that he would concede the deficiencies in tax and the penalties after I refused to enter an appearance on his behalf."

As part of his attempt to protect Mrs. Gebman from collateral damage, he noted that he planned to offer up an innocent spouse defense for her. Since part of the assessment resulted from failure to report IRA distributions from Mrs. Gebman's account, the attorney planned to present evidence that Mr. Gebman had fraudulently withdrawn the funds without Mr. Gebman's consent.

Believing that there was a plan in place, the attorney returned to Court with Mr. Gebman, appearing as representative of Mrs. Gebman. As the opinion describes that hearing:

> We recalled the case at 1 p.m., at which time Mr. Gebman again introduced himself, and Mr. Agostino stated that he would be entering an appearance for Mrs. Gebman. We asked whether there was anything preliminary to discuss. Mr. Agostino stated: "Yes. Your Honor. With respect to Clark Gebman, Mr. Gebman will be conceding the deficiency in full." We inquired: "Are you representing him?" Mr. Agostino said that Mr. Gebman would get up. Mr. Gebman arose and said: "I would do as John was saying." We assume that he meant "Frank" (i.e., Mr. Agostino), and Mr. Agostino agrees. We then asked: "Okay. So, a concession to the deficiency in full by petitioner husband?" Mr. Agostino replied: "Yes." Respondent's counsel then asked about the penalty, and Mr. Agostino added: "And penalty." We inquired of Mr. Gebman as to the penalty. He responded: "I'm going to do what's best for my family, your Honor. And I've been counseled that I've made a mistake, and I need to be accountable to the Government. And I am fully prepared to, whatever I can within my means to do so." He agreed to concede the penalty.
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> Discussion then turned to Mrs. Gebman, whom Mr. Agostino said wished to raise an innocent spouse defense. He recognized that Mrs. Gebman required leave of the Court to amend the petition in order to raise the defense. Following additional discussion, the Court agreed to continue the case to give Mrs. Gebman time to move for leave to amend the petition to raise an innocent spouse defense. Mr. Agostino represented that Mrs. Gebman would stipulate the correctness of all of respondent's adjustments and penalties, relying only on the innocent spouse defense that she hoped to raise. The Court asked Mr. Gebman whether he agreed to that, and he responded that he did. By order dated January 30, we continued the case and gave Mrs. Gebman until March 1, 2017, to move for leave to amend petition. On January 30, we filed Mr. Agostino's appearance on behalf of Mrs. Gebman.

All is well so far, with the attorney representing the wife in what would be an innocent spouse defense and Mr. Gebman conceding all the tax deficiency. The attorney was also aware that Mr. Gebman had little income and few assets, so even though he would be stuck with a large balance due, the IRS most likely would be forced to classify his account as "currently not collectible" so there likely wouldn't be any real negative consequence for Mr. Gebman.

But a problem arose—Mr. Gebman had a change of heart shortly thereafter. He still wanted his wife protected, but he now wanted to fight the tax assessments and all the IRS adjustments, including the IRA distribution issue.

The Tax Court found that this create a conflict of interest issue for the attorney. While the attorney attempted to get Mr. Gebman to sign a waiver, Mr. Gebman refused to sign the document. The attorney argued that he had never been Mr. Gebman's attorney and, in any event, there would be negative consequence to Mr. Gebman if Mrs. Gebman succeeded in obtaining innocent spouse relief.

The Court disagreed. First, the Court noted that responsibilities to avoid conflicting interests involve not just clients, but also individuals who do not become clients but who consulted with the

attorney. In this case it was a bit complicated, with the Court concluding that Mr. Gebman was a client for a brief period, but that by now Mr. Gebman was a former client.

As the Court explained the issues:

> While Mr. Agostino was not counsel of record for Mr. Gebman, he formerly represented Mr. Gebman in connection with the tax dispute before us. As used in the Model Rules, the verb "represent" is a term of art. The preamble to the Model Rules, in discussing a lawyer's responsibilities, describes a lawyer, as among other things, "a representative of clients" and further states that, "[a]s a representative * * * a lawyer performs various functions", including, among others, "advisor", "advocate", "negotiator", and "evaluator". Model Rules, preamble, r. 1.8(a) cmts. Mr. Agostino concedes that he acted both as an adviser and as an evaluator to Mr. Gebman and as an advocate and negotiator to Mrs. Gebman. We now consider whether Mr. Agostino is representing Mrs. Gebman in the same, or substantially the same, matter as that in which he represented Mr. Gebman, whether Mrs. Gebman's interests in the matter are materially adverse to Mr. Gebman's interests, and (since we find that her interests are materially adverse to his interests) whether Mr. Agostino obtained from Mr. Gebman informed consent in writing.

The Court, evaluating the issues, concluded that the attorney's argument to obtain innocent spouse relief for Mrs. Gebman would directly violate his duties to Mr. Gebman, and that no informed consent had been obtained from Mr. Gebman to allow him to move forward regardless:

> As framed by the notice of deficiency and the petition, the legal dispute before us is whether respondent may assess against petitioners some or all of the deficiencies and penalties that he determined. Mrs. Gebman has agreed to concede that the adjustments and penalties are correct, but she would like to be relieved of liability for the tax and penalties with respect to at least the IRA distributions on the grounds that, with respect to the resulting tax liabilities and penalties, she is an innocent spouse, or, to put it another way, that omission of the IRA distributions from petitioners' joint income was an erroneous item of Mr. Gebman's or that he fraudulently converted the IRA distributions to his own use and should have reported the resulting income. Facts concerning the IRAs are central to her innocent spouse defense. Mr. Gebman may dispute the facts as Mrs. Gebman construes them, or he may construe them differently. In any event, his defense of their joint return position and her innocent spouse claim involve the same transactions (IRA distributions) and a dispute as to their tax consequences. Mr. Gebman's intent to defend their return position (if allowed to) puts Mr. Agostino (in representing Mrs. Gebman) on the other side from Mr. Gebman (he says that the IRA distributions were not includible in their gross income, she would concede that they were, and, moreover, she wants to claim that it was his (and not her) income).

Representing spouses always has the inherent risk of conflict of interest issues. In this case the attorney reasonably concluded at his meeting with the taxpayer just before the Court appearance that he had permission to proceed with a defense of the spouse.

But even if there was a waiver (and, in this case that waiver was never reduced to writing), such a waiver is permission to go forward "for now" and fails to apply if there is a material change in

circumstances. In this case, the husband's decision to attempt to get his original concession of the liabilities reversed was just such a material change in circumstances.

While this case involved the specific provisions of the American Bar Association's Model Code of Conduct as applied to attorneys, the rules that apply for all engagements to CPAs via the AICPA *Code of Professional Conduct* and to CPAs, EAs and attorneys under Circular 230 when representing clients before the IRA are either very similar or identical to the ABA rules. Even when being a "nice guy" and handling matters without a fee, the adviser must still follow these rules.

SECTION: 61
PAYMENT FROM QUALIFIED SETTLEMENT FUND FOR FORECLOSURE IRREGULARITIES IS FULLY TAXABLE TO RECIPIENT

Citation: Ritter v. Commissioner, TC Memo 2017-185, 9/19/17

Clients who receive legal settlements often believe that because they have been awarded damages for a wrong that occurred the payment is not subject to income taxes. But the tax law is not so simple. The default under federal tax law, found at IRC §61(a), is that all items of income are taxable, with the burden falling on the taxpayer to point out an exception that applies in his/her case.

The case of *Ritter v. Commissioner*, TC Memo 2017-185, looks at an award received by a homeowner whose house was taken in a foreclosure proceeding. The taxpayer received a payment related to a settlement between the lender and the government to deal with, as the Office of the Comptroller of the Currency labeled it, "deficiencies and unsafe or unsound practices in [Chase Bank's] residential mortgage servicing and in the Bank's initiation and handling of foreclosure proceedings."

The settlement agreement provided that the bank would establish a "qualified settlement fund" (QSF) within the meaning of Treas. Reg. §1.468B-1. Payments from this fund would be made to various qualified homeowners. The homeowners would not be required to show any specific financial harm to receive a payment from the fund. As well, the settlement agreement provided that the payments were not for any specific financial injury or harm to the borrowers, and no portion of the award was designated for lost equity.

Mr. Ritter received a check for $31,250 from the QSF. The QSF issued a 2013 Form 1099-MISC to Mr. Ritter showing the payment as "other income" for 2013. Along with the 1099 was a letter that explained this amount related to the payment Mr. Ritter received related to his mortgage.

Whether a payment as part of a legal settlement is taxable to the recipient requires a determination of why the damages were being awarded—was it to reimburse a taxpayer for a specific financial cost that had been incurred, did it represent addition amounts the taxpayer should have received for the disposition of the home, etc. Unless the taxpayer establishes a "why" that has a specific exception from taxation, the proceeds would be taxable.

This case involved the special tax entity known as a *qualified settlement fund* as described in IRC §468B. As the Court notes:

> Section 468B and the regulations thereunder provide special rules for the taxation of a designated settlement fund, like the QSF. Pursuant to section 1.468B-4, Income Tax Regs., whether a distribution from a designated settlement fund, like the QSF, is includible in a payee's gross income is generally determined by reference to the claim in respect of which the distribution is made and as if the distribution were made directly to the payee by the transferor to the designated settlement fund.

In this case, the Court found that the payment did not meet any criteria that would allow it to be excluded from income:

> The distribution plan for distributions from the QSF established different categories of borrowers that were based upon different loan file characteristics and whether the borrower requested a review through the IFR. The OCC and the Federal Reserve Board determined in their sole discretion a specific payment amount, a so-called standard payout amount, for each category of borrowers. Pursuant to the distribution plan, petitioner was categorized as a borrower who did not request review through the IFR and whose mortgage loan servicer (i.e., Chase Bank) initiated or completed foreclosure with respect to the mortgage loan on petitioner's then principal residence while he was protected by Federal bankruptcy law. Petitioner's category of borrowers was not eligible for a payment representing lost equity. Like all borrowers so categorized, the OCC and the Federal Reserve Board had determined that the standard payout amount payable to petitioner's category of borrowers was $31,250.
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> The fully stipulated record is devoid of evidence establishing that the $31,250 payment was, or was intended to be, a deemed increase or decrease in the amount realized by petitioner from the foreclosure with respect to the mortgage loan on his then principal residence. Nor does that record contain any evidence establishing that petitioner is entitled under a specific Code section to exclude that payment from gross income.

SECTION: 355
IRS SETS UP 18 MONTH PILOT PROGRAM FOR ISSUING CERTAIN RULING REQUESTS ON TAX FREE DISTRIBUTIONS OF STOCK

Citation: Revenue Procedure 2017-52, 9/21/17

The IRS announced a pilot program where it would accept private letter ruling requests on general federal tax consequences of transactions that aimed to be tax free distributions of corporate stock. The transactions would be ones intended to qualify under IRC §§368(a)(1)(D) ("D" reorganizations) and 355.

The program, described in Rev. Proc. 2017-52, will run for 18 months after which the IRS will evaluate the program and whether it makes sense to terminate it, extend it or expand it.

The IRS had greatly reduced the rulings it would issue for such transactions in Rev. Proc. 2013-32, accepting ruling requests only for significant issues related to such transactions. That ruling held

that "a significant issue is an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction." [Rev. Rul. 2013-32, Section 4.02(3)]

The new ruling expands the topics outside of the "significant issue" arena to include certain other items. To be covered by this ruling, the transaction must be a "Covered Transaction" which is defined as "(i) a transaction intended to qualify under §§ 368(a)(1)(D) and 355 or (ii) a distribution that is intended to qualify under §§ 355(a) and 355(c)." [Rev. Rul. 2017-52, Section 2.03(1)(a)]

The IRS will issue "Transactional Rulings" related to specific provisions of the law. The procedure defines a "Transactional Ruling" as "a letter ruling that addresses the general federal income tax consequences of a Covered Transaction."

The procedure goes on to describe areas the IRS will rule in this area as:

> A Transactional Ruling may include the tax consequences of a Covered Transaction under §§ 312, 355, 357, 358, 361, 362(b), 362(e), 368(a)(1)(D), 368(b), 1032(a), 1223(1) and 1223(2), and relevant consolidated return regulations. The Service may decline to rule on tax consequences under any provision of the Code or the regulations or may include rulings under provisions other than those listed above.

The ruling does not change areas where the IRS has explicitly provided a "no ruling" policy. As the procedure notes:

> This revenue procedure does not alter the Service's policy that limits rulings on the device prohibition under § 355(a)(1)(B) and § 1.355-2(d), the business purpose requirement under § 1.355-2(b), and whether a distribution is pursuant to a plan under § 355(e). See section 3.01(54) of Rev. Proc. 2017-3, as modified by section 5.07 of this revenue procedure, and sections 3.03(6), 3.03(7), and 3.03(16) of this revenue procedure. More generally, see Rev. Proc. 2017-3 for other no-rule areas under § 355.

The procedure describes details of the process a taxpayer who wishes to request such a ruling must use.

SECTION: 6052
PROPOSED REGULATIONS ISSUED THAT WOULD ALLOW USE OF TRUNCATED SOCIAL SECURITY NUMBERS ON W-2S ISSUED TO EMPLOYEES

Citation: REG-105004-16, 9/20/17

The IRS has issued proposed regulations that would allow employers to truncate social security numbers (SSNs) on the employee copies of Forms W-2 in REG-105004-16. However, the IRS has announced that the option won't be available for W-2s issued before December 31, 2018.

Prior to a change in the law found in the PATH Act, IRC §6051(a)(2) required the employee's social security to be printed in full on the employee's copy of Form W-2. Due to concerns regarding identity theft, Congress changed the law to remove that requirement. However, the law did not mandate the use of truncated numbers and the regulations continue to require use of the employee's entire social security number.

The revised regulation would allow the use of "truncated taxpayer identification numbers" (TTIN) on Forms W-2 issued to employees. Reg. §301.6109-4(b) provides the definition of such numbers which currently are authorized to be used on other information reporting forms. As the preamble describes a TTIN:

> Under §301.6109-4(a), a TTIN is an individual's SSN, IRS individual taxpayer identification number (ITIN), IRS adoption taxpayer identification number (ATIN), or IRS employer identification number (EIN) in which the first five digits of the nine-digit number are replaced with Xs or asterisks. For example, a TTIN replacing an SSN appears in the form XXX–XX–1234 or ***–**–1234. Section 301.6109-4(b)(2)(ii) prohibits using TTINs if, among other things, a statute, regulation, other guidance published in the Internal Revenue Bulletin, form, or instructions specifically requires the use of an SSN. Additionally, §301.6109-4(b)(2)(iii) prohibits the use of TTINs on any return, statement, or other document that is required to be filed with or furnished to the IRS.

The regulations would still require full SSNs on the copy filed with the Social Security Administration.

The regulation makes certain changes that remove obsolete provisions and cross-references from the regulations.

But, as was noted earlier, 2017 W-2s will not be covered by this rule. The IRS explains the reason for this delay by noting:

> Several state tax administrators have requested additional time to develop systems to process the copies of Forms W-2 filed with state income tax returns that may contain truncated SSNs. In light of this request, these proposed regulations will not apply to Forms W-2 required to be furnished before January 1, 2019. Accordingly, these proposed regulations provide that these regulations, as amended, will be applicable for statements required to be filed and furnished under sections 6051 and 6052 after December 31, 2018.

SECTION: 7508A
TAX RELATED RELIEF FOR TAXPAYERS AFFECTED BY HURRICANES HARVEY AND IRMA

Citation: IRS News Releases IR-2017-135, IR-2017-150 and IR 2017-156, 9/19/17 and Texas Comptroller of Public Accounts "Declared Natural Disasters and Emergencies Tax Help", 8/28/17

The IRS and the Texas Comptroller have announced forms of due date and other relief for individuals impacted by Hurricane and Tropical Storm Harvey in Houston and surrounding areas. Federal relief was later provided for victims of Hurricane Irma in Florida, Georgia and Puerto Rico.

The IRS has announced information related to relief provided under IRC §7508A for performing certain acts in News Release IR-2017-135. IRC §7805A provides that the IRS may authorize a delay of up to one year to allow taxpayers to perform certain acts when the taxpayer is affected by a federally declared disaster or terroristic or military action. Similar relief was extended to taxpayers in Florida and Puerto Rico affected by Hurricane Irma in News Release 2017-150. The IRS later also

extended that same relief to those affected by Irma in the entire state of Georgia in News Release 2017-156.

The areas eligible for relief can be found on the IRS Disaster Relief web page.

The IRS relief is automatically granted to any taxpayer with an address of record located in the disaster area. Those who live outside the disaster area but whose records are located within the disaster area and relief workers working with a recognized organization need to contact the IRS at 866-562-5227 to discuss relief.

The IRS describes the affected tax deadlines for those affected by Hurricane Harvey:

> The tax relief postpones various tax filing and payment deadlines that occurred starting on Aug. 23, 2017. As a result, affected individuals and businesses will have until Jan. 31, 2018, to file returns and pay any taxes that were originally due during this period. This includes the Sept. 15, 2017 and Jan. 16, 2018 deadlines for making quarterly estimated tax payments. For individual tax filers, it also includes 2016 income tax returns that received a tax-filing extension until Oct. 16, 2017. The IRS noted, however, that because tax payments related to these 2016 returns were originally due on April 18, 2017, those payments are not eligible for this relief.
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> A variety of business tax deadlines are also affected including the Oct. 31 deadline for quarterly payroll and excise tax returns. In addition, the IRS is waiving late-deposit penalties for federal payroll and excise tax deposits normally due on or after Aug. 23 and before Sept. 7, if the deposits are made by Sept. 7, 2017. Details on available relief can be found on the disaster relief page on IRS.gov.

The relief for Irma is similar, though the dates are revised to affect the dates that disaster areas were declared for that storm. The same January 31, 2018 deadline is available for filing returns due after September 4, 2017 in Florida, September 5, 2017 in Puerto Rico and September 7, 2017 in Georgia. The payroll tax deposit date is pushed back to 15 days after the above dates for those affected by Irma.

The news relief also reminds taxpayers that suffered uninsured disaster-related losses may claim elect to claim the losses on their return for the year of loss (2017) or the previous year (2016). See IRC §165(I) and Temporary Reg. §1.165-11T for information on this option. Advisers should point to affected clients that even personal casualty losses may be used in the computation of a federal net operating loss available for carryback (IRC §172(d)(4)(C)).

Similarly, a three year net operating loss carryback period (rather than the standard two year periods) is available for

- Net operating losses arising from a casualty losses of an individual (IRC §172(b)(1)(E)(ii)(I)) and
- Net operating losses of a "small business" attributable to a federally declared disaster (IRC §172(b)(1)(E)(ii)(II).

For this purpose, a "small business" is generally one that has average gross receipts for the prior three years of less than $5,000,000. (IRC §172(b)(1)(E)(iii) ; IRC §448(c))

The Comptroller of the State of Texas has also announced various forms of tax relief available to affected taxpayers related to various state taxes. The information is found in a page containing frequently asked questions on disaster relief on the agency's website.

The page notes that, unlike the IRS relief, affected who cannot timely file taxes with the Comptroller's office will need to contact the agency. The page states:

> Some taxpayers may be unable to file taxes timely due to damage caused by a declared natural disaster. The Comptroller can grant an extension of up to 90 days to file tax returns to a business affected by a declared disaster. An affected business must request the extension. These types of extension requests are handled on a case-by-case basis. For more information or to request a tax filing extension, call the Comptroller's tax assistance line at 800-252-5555.

The page also notes that the Governor of Texas has issued certain proclamations on exemptions for certain sales and other taxes. The FAQ page has information on this relief, which at the time this article was written included certain relief from hotel taxes and sales taxes, as well as relief for out of state businesses performing disaster or emergency related work in Texas.

In the past, such relief has often covered an expanded area in the case of storms such as Harvey, as the storm affects additional areas as it continues to move. Advisers should be sure to continue to monitor developments with the various taxing agencies to see if clients may qualify for some form of relief.