Current Federal Tax Developments

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Section: 62
Waiver of Repayment of Excess Pension Payment Not Taxable as Cancellation of Indebtedness

Citation: PLR 201743011, 10/27/17

In Private Letter Ruling 201743011 a taxpayer sought clarification that he would not end up having to effectively report the same income twice despite receiving information returns in different years that reported what was the same income.

The taxpayer had received payments from a pension plan to which the taxpayer had made after-tax contributions for several years. The taxpayer reported his payments using the simplified safe harbor method of reporting his income pursuant to Notice 88-118, determining the taxable portion of each payment and the amount that represented a nontaxable return of capital.

Eventually the taxpayer was notified that the plan had determined he had been paid more from the plan than he should have received due to systemic errors made many years before. The letter indicated that his payments were scheduled to be reduced in the future to recover this overpayment. However, the plan had the discretion to waive the overpayment if the recipient satisfied certain criteria.

The plan determined that the taxpayer met the criteria and thus waived any repayment of the overpayment to be made by the taxpayer. Due to having waived the repayment, the plan is going to furnish the taxpayer a *Form 1099C, Cancellation of Debt* showing the overpayment as cancellation of debt income.

As the taxpayer had already reported a portion of the amounts in question as income, the question naturally arises about whether the taxpayer is going to end up having to report that same amount again as income. The taxpayer asked for a private letter ruling providing that he did not have taxable income from the plan's waiver of repayment.

The IRS agreed that that the taxpayer was correct. As the ruling notes:

> Ordinarily, you would be obligated to repay the amount of the $x pension overpayment. The Department, however, waived the collection of the overpayment, which it is authorized to do. The $x discharge of indebtedness is not gross income under § 61 because you accounted for all your pension payments under the Pension Plan (including the $x overpayment) under Notice 88-118 as you received them.

Section: 401
IRS Allows Retirement Plans to Allow Those Affected by Specified 2017 Disasters to Receive Loans and/or Hardship Distributions Under Simplified Procedures

Citation: Announcement 2017-11, 8/31/17, Announcement 2017-13, 9/12/17, Announcement 2017-15, 10/31/17

In Announcement 2017-11 the IRS has provided special provisions to allow qualified employer retirement plans to make Hurricane Harvey related distributions and/or loans. Following Hurricane Irma, the IRS in Announcement 2017-13 expanded the relief to cover those impacted

by Hurricane Irma. Similar relief was provided to victims of Hurricane Maria and the Northern California wildfires in [Announcement 2017-15](#).

The general relief is described in the notice as follows:

> …[A] qualified employer plan will not be treated as failing to satisfy any requirement under the Code or regulations merely because the plan makes a loan, or a hardship distribution for a need arising from Hurricane Harvey, to an employee or former employee whose principal residence on August 23, 2017, was located in one of the Texas counties identified for individual assistance by the Federal Emergency Management Agency ("FEMA") because of the devastation caused by Hurricane Harvey or whose place of employment was located in one of these counties on that applicable date or whose lineal ascendant or descendant, dependent, or spouse had a principal residence or place of employment in one of these counties on that date.

For Irma the only real change is changing the reference to Irma and moving the beginning date to September 4, 2017. Similarly, later dates apply for Hurricane Maria and the California wildfires.

The counties identified for assistance covered by these announcements can be found at https://www.fema.gov/diasters. The relief will begin on the date each area is named as disaster area on the FEMA website.

The announcement provides for liberal rules on hardship distributions. The distribution amount would be limited to the maximum amount that would be available for a hardship distribution under the Code and regulations. However, the distribution is available to eligible individuals adversely affected by Hurricanes Harvey or Irma who wish to use assets in qualified employer plans to alleviate hardships caused by Hurricanes Harvey or Irma. This means that such a distribution applies to any hardship of the employee, not just the types listed in the regulations. As well, no post-distribution contribution restrictions are required. Normally an employee taking a hardship distribution is prohibited from making contributions for at least 6 months after the distribution, but that rule will not apply for Harvey and Irma related hardship distributions.

The plan administrator can rely upon the representations of the participant about the need for and amount of the specified disaster related hardship distribution unless the administrator has actual knowledge to the contrary.

While the plan must be of a type that would be eligible to offer hardship distributions, the plan language does not need to provide currently for hardship distributions to make them under this relief. So, for instance, a profit sharing or stock bonus plan could make a hardship distribution under this relief regardless of whether it contained hardship distribution language. However, plans prohibited from making hardship distributions by the law cannot make them under this rule—that would include a defined benefit or money purchase pension plan except for assets in such a plan that are in a separate account within the plan containing employee contributions or rollover contributions.

The maximum hardship distribution is limited to the maximum amount that would be allowed under the law if the plan had language allowing for a hardship distribution.

While the language allowing for hardship distributions or loans does not need to be in the plan document currently, the plan must be amended to provide for them no later than the end of the

first plan year beginning after December 31, 2017. A hardship distribution under this relief provision must be made:

- Because a hardship arising from Hurricane Harvey or Irma
- Be made on or after the specified beginning date for each disaster) and
- Be made no later than January 31, 2018 (for Hurricanes Harvey and Irma) and March 15, 2018 for Hurricane Maria and the Northern California wildfires

Plan loans under this provision must satisfy the requirements of IRC §72(p). Thus, the loans must meet the $50,000 maximum amount rule found at IRC §72(p)(2)(A)(i), taking into account any other plans loans taken out by the participant during the relevant one-year period or, if less, the greater of ½ of the present value of the employee's nonforfeitable accrued benefit or $10,000 per IRC §72(p)(2)(A)(ii).

Special relief is granted for procedural rules as described below:

> In addition, a retirement plan will not be treated as failing to follow procedural requirements for plan loans (in the case of retirement plans other than IRAs) or distributions (in the case of all retirement plans, including IRAs) imposed by the terms of the plan merely because those requirements are disregarded for any period beginning on or after August 23, 2017, and continuing through January 31, 2018, with respect to loans or distributions to individuals described in the first paragraph under "Relief", above, provided the plan administrator (or financial institution in the case of distributions from IRAs) makes a good-faith diligent effort under the circumstances to comply with those requirements. However, as soon as practicable, the plan administrator (or financial institution in the case of IRAs) must make a reasonable attempt to assemble any forgone documentation. For example, if spousal consent is required for a plan loan or distribution and the plan terms require production of a death certificate if the employee claims his or her spouse is deceased, the plan will not be disqualified for failure to operate in accordance with its terms if it makes a loan or distribution to an individual described in the first paragraph under "Relief" in the absence of a death certificate if it is reasonable to believe, under the circumstances, that the spouse is deceased, the loan or distribution is made no later than January 31, 2018, and the plan administrator makes reasonable efforts to obtain the death certificate as soon as practicable.

Note that the taxation of such distributions to the participant is not changed by these rules. As the announcement warns:

> Taxpayers are reminded that in general the normal spousal consent rules continue to apply, and, except to the extent the distribution consists of already-taxed amounts, any distribution made pursuant to the relief provided in this announcement will be includible in gross income and generally subject to the 10-percent additional tax under § 72(t).

Similarly, if the participant takes out a loan, the same rules that lead to a deemed distribution equal to the balance of the loan based on certain uncorrected failures to comply with the loan requirements would also continue to apply.

The announcements each conclude by noting that the Department of Labor that it will not treat any person as violating the provisions of Title I of the Employment Retirement Income Security Act because that person complied with the provisions of either announcement.

Section: 1001
Taxpayer's Loss Generated Using a Family Limited Partnership Formed With Assets Contributed to S Corporation Lacked Economic Substance

Citation: Smith v. Commissioner, TC Memo 2017-218, 11/6/17

An attempt to combine the concepts of valuation discounts for family limited partnership often used in estate planning with a short-lived S corporation to create an income tax benefit was not looked upon positively by the Tax Court in the case of *Smith v. Commissioner*, TC Memo 2017-218.

The taxpayer had substantial income in 2009 that arose from a bonus and other income he received when his employer of 36 years was sold, the same year in which Mr. Smith retired. Faced with the sudden influx of income, Mr. Smith consulted an estate planning attorney who suggested the following plan as outlined in the opinion:

> *Mr. Shanks also recommended a tax planning strategy intended to mitigate the effect on petitioners' tax liability of Mr. Smith's compensation from National Coupling. The tax structure involved the organization of an S corporation and the formation of a family limited partnership. Under the structure, petitioners would transfer their cash and marketable securities to a wholly owned S corporation that would then transfer the assets to a family limited partnership. Mr. Shanks explained to petitioners that the family limited partnership would provide asset protection. The S corporation would own the limited partnership, and the partnership would hold petitioners' cash and marketable securities. As part of the structure, petitioners would organize and dissolve the S corporation within the same tax year. The S corporation would distribute the partnership interest to the shareholders upon dissolution. Mr. Shanks would determine the fair market value of the distributed partnership interest using large discounts for lack of marketability and lack of control, generating a tax loss upon the dissolution of the S corporation. The S corporation's dissolution and the distribution of the partnership interest were both necessary to generate the tax loss. A third entity in the planning structure was a revocable management trust that would hold the general partnership interest. Mr. Shanks advised that the tax structure could generate either a capital or an ordinary loss deduction on the basis of the business purpose of the S corporation. He had implemented similar structures for 10 to 15 other clients between 1999 and 2009.*

The IRS attacked this structure, claiming that it lacked economic substance since the structure had no effect aside from generating an income tax loss.

Since any appeal of the results on this case would be heard by the Fifth Circuit Court of Appeals, the Tax Court looked to the Fifth Circuit's holdings on how to determine if a transaction lacks economic substance. The Court outlined those standards as follows:

> *The Court of Appeals for the Fifth Circuit has interpreted the economic substance doctrine as a conjunctive "multi-factor test". Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States, 568 F.3d 537, 544 (5th Cir. 2009). In Klamath, the Court of Appeals stated that a transaction will be respected for tax purposes only if: (1) it has economic substance compelled by business or regulatory realities, (2) it is imbued with tax-independent considerations, and (3) it is not shaped totally by tax-avoidance features. Thus, a transaction must exhibit an objective economic reality,*

> *a subjectively genuine business purpose, and some motivation other than tax avoidance. Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors LLC v. United States, 659 F.3d 466, 480 (5th Cir. 2011). Failure to meet any one of these three factors renders the transaction void for tax purposes. Klamath, 568 F.3d at 544. While Klamath phrases the economic substance doctrine as a conjunctive, three-factor test, the Court of Appeals for the Fifth Circuit has recognized that "there is near-total overlap between the latter two factors. To say that a transaction is shaped totally by tax-avoidance features is, in essence, to say that the transaction is imbued solely with tax-dependent considerations." Southgate Master Fund, 659 F.3d at 480 & n.40.*

The Tax Court found this structure failed to meet any of the standards outlined by the Fifth Circuit.

The Court first noted that the structure did not change the "petitioners' economic position in any way that affected objective economic reality."

The Court also found that the taxpayers also failed to meet the final two standards, ones that are closely intertwined. The taxpayer had come up with a "business purpose" which the Court did not find persuasive.

The opinion noted:

> *Petitioners claim that they organized Ventures to manufacture the sprinkler device but changed their minds because the patent had not been issued by the end of 2009 and Mr. Smith was busy with his consulting work. The record is not clear as to whether Mr. Smith owned a right to the sprinkler device patent.4 Even if we assume that Mr. Smith had the right to the sprinkler device patent, we do not find petitioners' claims that they organized Ventures to manufacture the sprinkler device to be credible. First, Mr. Smith's testimony relating to the Canadian and U.S. patents conflicts with the record. He testified the Canadian patent was issued before the National Coupling sale, but documents in the record show that it was issued in October 2009. Mr. Smith also testified that on the basis of his experience he expected that the USPTO would issue the sprinkler device patent shortly after the Canadian patent's issuance. Thus, according to his testimony he should have expected the U.S. patent to be issued shortly after October 2009. However, petitioners began to dissolve Ventures only one month later. Mr. Smith is an experienced businessman familiar with patent procedure. The U.S. patent application was submitted in 2006. By the end of 2009 he had already waited three years for the patent. In the light of these inconsistencies, we do not find Mr. Smith's testimony that he intended to manufacture the sprinkler device through Ventures to be credible. Nor do we believe that petitioners decided to dissolve Ventures because the USPTO had not issued the sprinkler device patent by November 2009. Rather, we find that petitioners never intended to operate Ventures as a manufacturing business. They intended from the beginning of the RACR structure to organize and dissolve Ventures within the same year to generate a tax loss to minimize their 2009 income tax liability.*

Section: 1366
Loans from Related Corporations Did Not Shareholders Basis for Losses

Citation: Messina et ux. et al. v. Commissioner, TC Memo 2017-213, 10/30/17

The rules for obtaining basis for S corporation loans are often best viewed as emphasizing form over substance. The fact that a shareholder might be economically "on the hook" for ultimate repayment of the debt will not generally impact whether that person will be able to claim the debt as basis. The shareholders of an S corporation ran into this issue in the case *Messina et ux. et al. v. Commissioner*, TC Memo 2017-213.

In this situation, the controlling shareholders of an S corporation formed another S corporation that loaned funds to a qualified S corporation subsidiary (QSUB) of the first S corporation. The shareholders then attempted to claim losses from the first S corporation by use those loans as additional basis in the corporation—a position the IRS and, ultimately, the Tax Court disagreed with.

The second S corporation was formed on the advice of the taxpayers' counsel in order to work around a problem. The loan was to be used to refinance third party debt to the QSUB. However, by terms of the agreement with other creditors (who had sold the business to the S corporation originally), any amounts borrowed from the shareholders of the S corporation had to be subordinated to the original owner's debts. The attorney advised the taxpayers by using a new S corporation, no subordination of the new debt would be required.

The taxpayers first argued that the debt should be allowed because the new S corporation represented an "incorporated pocketbook" of the controlling shareholders, basing their position on prior caselaw. As the opinion summarizes the taxpayers' position:

> *Petitioners rely on a theory distilled from caselaw as summarized in Broz v. Commissioner, 137 T.C. at 62, that direct payments from a related entity to the taxpayer's S corporation constitute payments on the taxpayer's behalf where the taxpayer used the related entity as an "incorporated pocketbook." See Yates v. Commissioner, T.C. Memo. 2001-280; Culnen v. Commissioner, T.C. Memo. 2000-139, rev'd on other grounds, 28 F. App'x 116 (3d Cir. 2002). This Court has held that the term "incorporated pocketbook" refers to the taxpayer's habitual practice of having his wholly owned corporation pay money to third parties on his behalf and that whether an entity is an incorporated pocketbook is a question of fact. See Broz v. Commissioner, 137 T.C. at 62 (citing Ruckriegel v. Commissioner, T.C. Memo. 2006-78).*

But the Court found that, unlike the cases they relied upon, the taxpayers in this case hadn't regularly used the new corporation to pay payments on behalf of the taxpayers.

> *The "incorporated pocketbook" rationale is inapposite here. In both of the cases petitioners cite — Culnen and Yates — the taxpayers sought to regularly direct funds from one of their entities through themselves and on to an S corporation. Here, petitioners concede that Messrs. Messina and Kirkland did not use KMGI habitually to pay Casino's or their personal expenses. Instead, they argue that this is not a requirement but only evidence of indebtedness running directly to the shareholder. To the extent we [*33] would agree with that statement, the fact that KMGI did not make payments habitually does not help petitioners' case. To the contrary, it would be evidence against a finding that indebtedness runs from Club One and Casino directly to Messrs. Messina and Kirkland. At any rate, we disagree with petitioners' interpretation of Culnen and Yates. Frequent and habitual payments are key to a finding that a corporation served as an incorporated pocketbook. KMGI did not make frequent and habitual payments on behalf of its shareholders. Accordingly, we find that it did not function as Messrs. Messina and Kirkland's incorporated pocketbook.*

The taxpayers next argued that the new S corporation should be treated as merely acting as an agent for the taxpayers.

> *Petitioners emphasize that Messrs. Messina and Kirkland contributed to KMGI, which had no assets or other business activity besides the loan acquisition, all the funds necessary to purchase the D.B. Zwirn loan and that KMGI served effectively as a conduit for payments from Casino. Petitioners also contend that Messrs. Messina and Kirkland advised the parties involved in the loan acquisition that [*35] KMGI was purchasing the loan on behalf of Messrs. Messina and Kirkland and that doing so*

> *allowed the CGCC to grant its approval to the transaction more quickly than if the two owners had applied to CGCC in their individual capacities. Petitioners thus would have us hold that KMGI acted as agent for Messrs. Messina and Kirkland in purchasing the D.B. Zwirn loan from the Fortress Fund.*

The Tax Court did not accept this view either. Looking at the nine factors outlined by the Supreme Court for an agency relationship in the cases of *Nat'l Carbide Corp. v. Commissioner*, 336 U.S. 422, 437 (1949) and *Commissioner v. Bollinger*, 485 U.S. at 349-350 (1988), finding that only one of those factors resolves in favor of an agency relationship, while the others suggest the opposite result. Ultimately the Court holds:

> *The weight of the factors instead shows KMGI to be a distinct corporate entity. Accordingly, we find that KMGI was not Messrs. Messina and Kirkland's agent, nor was it a conduit.*

The taxpayers next tried to argue that the actual economic outlay was by the taxpayers and not the new S corporation, but the Court rejected that as well:

> *Petitioners, by their argument about actual economic outlay, essentially rehash the conclusion of their other two theories that KMGI was nothing more than a conduit or incorporated pocketbook that ought to be disregarded. We have already disposed of those theories. KMGI was a corporation with its own separate existence. Likewise it was not simply a shell corporation but a distinct entity with at least one substantial asset, the D.B. Zwirn loan, and a significant business purpose. Cf. Ashdown v. Commissioner, T.C. Memo. 1989-40, 56 T.C.M. (CCH) 1160, 1161 n.5 (1989) ("Neither party defined the term shell corporation although each of [*44] them used it. We assume it means a corporation which has no assets or has assets of very little value although it appears to be prosperous and successful on paper."). And the reclassification, from shareholder loans to additional paid-in capital, of Mr. Messina's and Mr. Kirkland's contributions of funds to KMGI in its books and records is further evidence as to the transaction's substance. Mr. Messina's and Mr. Kirkland's capital contributions, combined with KMGI's other indicia of actual corporate existence, are compelling evidence of economic outlay.*

Finally, the taxpayers tried to argue the Court should use a step transaction theory to collapse the transactions into a loan from the taxpayers to the original S corporation—but the Court declined to do so.

> *Under the step transaction doctrine "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction." Commissioner v. Clark, 489 U.S. 726, 738 (1989). The acquisition of the D.B. Zwirn loan consisted of only two steps: Mr. Messina's and Mr. Kirkland's transfers of funds to KMGI and the latter's purchase of the loan from the Fortress Fund. KMGI did not go on to resell the loan to Messrs. Messina and Kirkland or any other entity. Therefore, there was no step the consolidation of which with the other steps would allow the D.B. Zwirn loan to be treated as running directly from Messrs. Messina and Kirkland to Club One and Casino. Accordingly, we find that petitioners may not invoke the step transaction doctrine to hold that Messrs. Messina and Kirkland and not KMGI became the holders of the D.B. Zwirn after its acquisition from the Fortress Fund.*

Section: 9831
IRS Issues QSEHRA Guidance in FAQ Format

Citation: Notice 2017-67, 10/30/17

Late in 2016, as part of the 21st Century Cures Act, Congress had created a program under which certain qualifying small employers could pay directly for medical costs of certain employees (generally private health care insurance) without running afoul of the provisions of the Affordable Care Act that could subject the employer to a $100 per employee per day penalty for offering a health plan that did not comply with the standards imposed under that law.

These programs are referred to as "Qualified Small Employer Health Reimbursement Arrangements" (QSEHRAs) authorized by IRC §9831(d). In Notice 2017-67 the IRS issued a 59-page set of frequently asked questions (FAQs) regarding the operation of such plans to maintain compliance with the requirements of the law.

The questions and answers in the notice are divided into the following topics:

A. Eligible employer

B. Eligible employee

C. Same terms requirement

D. Statutory dollar limits

E. Written notice requirement

F. MEC (minimum essential coverage) requirement

G. Proof of MEC requirement

H. Substantiation requirement

I. Reimbursement of medical expenses

J. Reporting requirement

K. Coordination with PTC (premium tax credit)

L. Failure to satisfy the requirements to be a QSEHRA

M. Interaction with HSA (health savings account) requirements

N. Effective date

The notice provides detailed guidance to qualified employers sponsoring such programs. As the notice explains, to be eligible to offer such a program an employer must meet the following criteria:

> *To be an eligible employer that may provide a QSEHRA, the employer must not be an applicable large employer (ALE), as defined in section 4980H(c)(2) and the regulations thereunder (and, thus, may not be an employer that, generally, employed at least 50 full-time employees, including full-time equivalent employees, in the prior calendar year), and must not offer a group health plan (as defined in section 5000(b)) to any of its employees.*

In October the President issued Executive Order 13813 related to guidance on health reimbursement arrangements. This notice is meant to address the issues raised by that Order in addition to giving guidance under the law. As the Notice provides:

> *… Executive Order 13813 (82 Fed. Reg. 48385, Oct. 17, 2017), directed the Secretaries of the Treasury, Labor, and Health and Human Services to consider revising guidance, to the extent permitted by law and supported by sound policy, to increase the usability of health reimbursement arrangements (HRAs), expand employers' ability to offer HRAs to their employees, and to allow HRAs to be used in conjunction with non-group coverage. The guidance provided in this notice addresses each of those objectives. The Treasury Department (Treasury) and the Internal Revenue Service (IRS) anticipate that the Departments will issue additional guidance in the future in response to Executive Order 13813.*

Employers who have adopted or are considering adopting such an arrangement should review this guidance for information on what is and is not permitted under a QSEHRA program. The guidance in this Notice is effective for plan years beginning after November 19, 2017.