Current Federal Tax Developments

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Section: Legislation
Bipartisan Budget Act of 2018 Signed Into Law with Tax Provisions, Including Extenders

Citation: Bipartisan Budget Act of 2018, H.R. 1892, 2/9/18

The Bipartisan Budget Act of 2018, H.R. 1892, signed into law by President Trump on February 9, 2018, is best known for ending the very short government shutdown that took place for a few hours on February 9, 2018. But that bill also contained many tax related provisions in its 652 pages.

One key item to note is that the bill gave a one-year reprieve to 34 provisions that expired at the end of 2016. They still have expired (past tense), but the expiration date is now at the end of 2017. That means these benefits can be claimed on 2017 income tax returns.

As well, the law contains some special provisions related to both the California wildfires and Hurricanes Harvey, Irma, and Maria. The bill also restores some provisions pulled from the Tax Cuts and Jobs Act in the conference committee due to concerns they would have violated the Byrd rule.

But the bill did not include any technical corrections to the Tax Cuts and Jobs Act, including the provision on cooperatives the Tax Foundation has labeled the "grain glitch" where farmers would qualify for a large deduction for selling to cooperatives rather than other buyers.

The disaster relief accorded to those affected by California wildfires, found at Act Sections 20101 through 20104, provide similar relief for California wildfires as was granted to victims of Hurricanes Harvey, Irma and Maria in the Disaster Tax Relief and Airport and Airway Extension Act of 2017. That includes:

- Qualified retirement plan relief allowing for exemption from the early distribution excise tax under IRC §72(t) for qualified wildfire related distributions, the right to roll such funds back into a plan for three years from the date of the qualified distribution, the ability to return funds to a retirement plan that were withdrawn for a home purchase abandoned due to the wildfire and special rules related to the provision of loans from qualified plans.
- A similar employee retention credit as was provided to employers in the hurricane areas, granting a credit for continuing to pay employees when the place of business in the wildfire area was closed due to wildfire related issues.
- Suspending the 50% (or, for 2018, 60%) limit on charitable contribution if made for wildfire relief through the end of 2018
- Removing the 10% of adjusted gross income limit on personal casualty losses arising from the wildfire
- The ability for taxpayers in the affected areas to use either 2016 or 2017 amounts of earned income to compute the earned income tax credit. [Act Sections 20101-20104]

The extenders passed include a number that are very industry specific, but also ones that have broader appeal. The extenders are found beginning at Act Section 40001.

Those that are likely to impact a larger number of taxpayers (few of us are involved with thoroughbreds or are building tracks for NASCAR racing) include:

- Extension through the end of 2017 of the exclusion from gross income for discharge of qualified principal residence indebtedness under IRC §108(a)(1)(E) and the special rule on agreements related on such discharged that are entered into through the end of December 31, 2017 [Act Section 40201]
- Extends the deduction for qualified mortgage insurance premiums under IRC §163(h)(3)(E)(iv) through the end of 2017 [Act Section 40202]
- Extends the above-the-line deduction for tuition and related expenses through the end of 2017 [Act Section 40203]
- Extends the nonbusiness energy property credit and residential energy credit through the end of 2017 [Act Sections 40401-40402]

The bill also includes quite a few miscellaneous (that is the actual title given to them) provisions beginning at Act Section 41101. A number of these had been in the Tax Cuts and Jobs Act at some point but were pulled from that bill due to concerns they may have violated the Byrd rule in the Senate.

Many of them are not of general interest (at least if you aren't producing alcoholic beverages), but there are some of more general interest.

- The waiver of the limitations with respect to claims arising from the exclusion from gross income amounts received by wrongfully incarcerated individuals under IRC §139F is extended to three years from the date of enactment of the Protecting Americans from Tax Cuts Act (it had previously been one year). That will move the date to mid-December of 2018 [Act Section 41103]
- Individuals who have funds improperly levied from a retirement plan by the IRS may return the funds and interest by the date the tax return is due for the year the funds are returned [Act Section 41104, IRC §6343(f)]
- Freezing of the amount the IRS may charge as a user fee for installment agreements [Act Section 41105, IRC §6159(f)]

Additionally, the bill requires the IRS to create a new Form 1040SR for seniors, a form to be "as similar as practicable to Form 1040EZ" except that:

- The form shall be available only to individuals who have attained age 65 as of the close of the taxable year,
- The form may be used even if income for the taxable year includes —
    - Social security benefits (as defined in section 86(d) of the Internal Revenue Code of 1986),
    - Distributions from qualified retirement plans (as defined in section 4974(c) of such Code), annuities or other such deferred payment arrangements,
    - Interest and dividends, or
    - Capital gains and losses taken into account in determining adjusted net capital gain (as defined in section 1(h)(3) of such Code), and
- The form shall be available without regard to the amount of any item of taxable income or the total amount of taxable income for the taxable year. [Act Section 41106]

The form is required to be made available for tax years beginning after the date of enactment of this law (that is, February 9, 2018). Since that would appear to include fiscal year individual returns that would begin in 2018, the form presumably will be available for 2018 calendar year taxpayers (though the IRS could hold off and release the form only for fiscal year taxpayers and still comply with the letter of the law).

Section: Legislation
IRS Updates Priority Guidance Report for TCJA Implementation Issues

Citation: 2017-2018 Priority Guidance Report Second Quarter Update, 2/7/18

The IRS has released the second quarter update to the agency's 2017-2018 Priority Guidance Report which shows 18 projects added related to guidance implementing the Tax Cuts and Jobs Act.

Per the statement accompanying the report, it contains "guidance projects that we hope to complete during the twelve-month period from July 1, 2017, through June 30, 2018 (the plan year)."

The statement goes on to describe the additions found in this update:

> *This second quarter update to the 2017-2018 plan reflects 29 additional projects, including those that have become near term priorities as a result of the Tax Cuts and Jobs Act legislation enacted on December 22, 2017, as well as guidance we published (or released) during the period from October 13, 2017 through December 31, 2017.*

The 18 projects identified as related to initial implementation of the Tax Cuts and Jobs Act are:

- Guidance on certain issues related to the business credit under § 45S with respect to wages paid to qualifying employees during family and medical leave.
- Guidance under §§ 101 and 1016 and new § 6050Y regarding reportable policy sales of life insurance contracts.
- Guidance under § 162(m) regarding the application of the effective date provisions to the elimination of the exceptions for commissions and performance-based compensation from the definition of compensation subject to the deduction limit.
- Guidance under § 162(f) and new § 6050X.
- Computational, definitional, and other guidance under new § 163(j).
- Guidance on new § 168(k).
- Computational, definitional, and anti-avoidance guidance under new § 199A.
- Guidance adopting new small business accounting method changes under §§ 263A, 448, 460, and 471.
- Definitional and other guidance under new § 451(b) and (c).
- Guidance on computation of unrelated business taxable income for separate trades or businesses under new § 512(a)(6).
- Guidance implementing changes to § 529.
- Guidance implementing new § 965 and other international sections of the TCJA. (published 01/22/18 in IRB 2018-04 as Notice 2018-07 (Released 12/29/17)).
- Guidance implementing changes to § 1361 regarding electing small business trusts.
- Guidance regarding Opportunity Zones under §§ 1400Z-1 and 1400Z-2.

- Guidance under new § 1446(f) for dispositions of certain partnership interests. (To be published 02/12/18 in IRB 2018-07 as Notice 2018-08 (Released 12/29/17)).
- Guidance on computation of estate and gift taxes to reflect changes in the basic exclusion amount.
- Guidance regarding withholding under §§ 3402 and 3405 and optional flat rate withholding.
- Guidance on certain issues relating to the excise tax on excess remuneration paid by "applicable tax-exempt organizations" under § 4960.

Section: 165
Pyrrhotite Damage Revenue Procedure Modified to Extend Time to Pay for Repairs

Citation: Revenue Procedure 2018-14, 2/7/18

The IRS has revised the relief granted in Revenue Procedure 2017-60 by issuing Revenue Procedure 2018-14. The procedures apply to individuals who have damage to the concrete foundations of their personal residences caused by the presence of the mineral pyrrhotite.

As was described in the article that discussed the original relief provision posted on Current Federal Tax Developments:

> *The issue affects residents of the Northeastern United States due to the presence of pyrrhotite in the concrete mixture used to pour the affected foundations. The IRS notes that this is a mineral that naturally occurs in stone aggregate which is used to produce concrete. The mineral oxidizes in the presence of water and oxygen, leading to the formation of expansive mineral products and causing the concrete to deteriorate prematurely.*

That original notice was issued at the end of November 2017. In that notice, if the taxpayer obtained specific evidence from an engineer stating that the foundation contained the tainted concrete, a personal casualty loss deduction would be allowed in the year the repairs were paid for.

Less than a month later Congress passed Pub. L. 115-97 (the Tax Cuts and Jobs Act) that eliminated the ability to deduct personal casualty losses after the 2017 tax year. Not surprisingly, that lead many in the affected area to cry foul, arguing that to cut off relief so quickly was unfair.

The IRS has come up with a somewhat unique approach to fixing the problem, effectively allowing the payments for repairs to be made after December 31, 2017 but still be reflected as a loss on the 2017 income tax return.

The ruling provides the following rules for when a deduction is to be claimed for the damage caused by pyrrhotite (so long as the pyrrhotite existed in the foundation before January 1, 2018):

- If a taxpayer pays to repair damage to that taxpayer's personal residence caused by a deteriorating concrete foundation during the taxpayer's 2016 taxable year or earlier, the taxpayer may treat the amount paid as a casualty loss on a timely *Amended U.S. Individual Income Tax Return* (Form 1040X) for the taxable year of payment.
- If a taxpayer pays to repair the damage during the taxpayer's 2017 taxable year or prior to a timely filed (including extensions) original *U.S. Individual Income Tax Return* (Form

1040, 1040A or 1040EZ) for the 2017 taxable year, the taxpayer may treat the amount paid as a casualty loss on the taxpayer's original 2017 income tax return (or a timely filed Form 1040X for the 2017 taxable year).

- If a taxpayer pays to repair the damage after filing an original 2017 income tax return and prior to the last day for filing a timely Form 1040X for the 2017 taxable year, the taxpayer may treat the amount paid as a casualty loss on a timely filed Form 1040X for the 2017 taxable year.

The relief pushes the final date to make and pay for the repairs to a date more than three year later than would have occurred under the prior revenue procedure.

The provision still applies under the other conditions contained in the original procedure, specifically limiting relief to those who meet the following criteria:

> *The safe harbor under this revenue procedure is available to a taxpayer who has obtained a written evaluation from a licensed engineer indicating that the foundation was made with defective concrete, and has requested and received a reassessment report that shows the reduced reassessed value of the residential property based on the written evaluation from the engineer and an inspection pursuant to Connecticut Public Act No. 16-45 (Act). The safe harbor also is available to a taxpayer whose personal residence is either in Connecticut or outside of Connecticut, provided the taxpayer has obtained a written evaluation from a licensed engineer indicating that the foundation was made with defective concrete containing the mineral pyrrhotite.*

Section: 415
2018 Plan and IRA Numbers Are Not Changed by TCJA Provisions

Citation: News Release 2018-19, 2/6/18

The IRS has begun the process of indicating which inflation adjusted numbers will or will not change due to revisions made in the Tax Cuts and Jobs Act. In News Release IR-2018-19 the IRS has clarified that the qualified retirement plan and IRA amounts for 2018 originally announced in News Release IR-2017-177 and Notice 2017-64 will not require changes in amounts due to the Tax Cuts and Jobs Act.

Most of the numbers in that release were not at risk, since the inflation adjustment for the various numbers related to qualified plans are computed using procedures similar to those used to calculate cost of living adjustments under the Social Security Act. The TCJA made no changes to that computation.

However, the various IRA amounts were potentially impacted by the change from CPI-U to the chained CPI (C-CPI-U) for tax rate indexing under the TCJA. But, after running the numbers, the IRS found no change in the numbers was necessary.

As the release notes:

> *The tax law also specifies that contribution limits for IRAs, as well as the income thresholds related to IRAs and the saver's credit, are to be adjusted for changes in the cost of living using procedures that are used to make cost-of-living adjustments that apply to many of the basic income tax parameters.*

> *Although the new law made changes to how these cost of living adjustments are made, after taking the applicable rounding rules into account, the amounts for 2018 in the news release and the guidance remain unchanged.*

Section: 1366
Change in 2014 S Corporation Loan Regulations Did Not Change Result When Loans Came from Related Corporations

Citation: Meruelo v. Commissioner, TC Memo 2018-16, 2/5/18

In the case of *Meruelo v. Commissioner*, TC Memo 2018-16 a taxpayer argued that an IRS change in regulations related to S corporations loans made in 2014 meant that he did not need to show he was actually economically worse off following a purported loan to obtain basis for deducting losses. Unfortunately for the taxpayer, the Tax Court ruled that the new regulations did not remove the requirement that the taxpayer show he/she is economically worse off to obtain basis in what the taxpayer claims is a loan from him/her to the S corporation.

In 2014 the IRS revised the regulations related to S corporation debt. As the preamble to the final regulations noted:

> *Courts developed the actual economic outlay standard, which requires that shareholders be made "poorer in a material sense" to increase their bases of indebtedness. Some courts concluded that an S corporation shareholder was not poorer in a material sense if the shareholder borrowed funds from a related entity and then lent those funds to his S corporation. See, for example, Oren v. Commissioner, 357 F.3d 854 (8th Cir. 2004), aff'g, T.C. Memo. 2002-172. Instead of applying the actual economic outlay standard, the proposed regulations provided that shareholders receive basis of indebtedness if it is bona fide indebtedness of the S corporation to the shareholder.*[1]

The final regulations specifically provided at Reg. 1.136-2(a)(2):

> *The term basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in § 1.1011-1 and as specifically provided in section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances.*

In this case the taxpayer had several related S corporations, one of which was Merco of the Palm Beaches, Inc. (Merco). Merco had purchased a condominium complex in bankruptcy. As sometimes happens, the taxpayer made payments of expenses out of entities that often weren't the one that incurred the expense, creating a significant amount of inter-affiliate debts. As the Court explained the matter:

> *During 2004-2008 Merco entered into hundreds of transactions with various partnerships, S corporations, and LLCs in which petitioner held an interest (collectively, Merco affiliates). Merco affiliates regularly paid expenses (such as payroll costs) on each other's or on Merco's behalf to simplify accounting and enhance liquidity. The payor company recorded these payments on behalf of its affiliates as accounts receivable, and the payee company recorded such items as accounts payable.*

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[1] T.D. 9682; 79 F.R. 42675-42678

> *During 2004-2008 Merco affiliates made payments in excess of $15 million to or on behalf of Merco. Merco repaid its affiliates less than $6 million of these advances. On December 31 of each year, Merco's books and records showed substantial net accounts payable to its affiliates.*

The taxpayer's CPA, recognizing that debts from the affiliates to Merco did not create basis for the shareholder, made journal entries each year to transfer any net amount due at the end of the year to a shareholder loan account in an attempt to "fix" this problem. The CPA, recognizing that a mere journal entry wouldn't create a true debt on its own, drafted a promissory note from the corporation to the shareholder for a $10 million line of credit, with interest due at 6%.

But the Court pointed out some issues with this credit line. The opinion notes:

> *…[T]here is no documentary evidence that such adjustments to principal were actually made or that Merco accrued interest annually on its books with respect to this alleged indebtedness. There is no evidence that Merco made any payments of principal or interest on its line of credit to petitioner. And there is no evidence that petitioner made any payments on the loans that Merco affiliates extended to Merco when they transferred money to it or paid its expenses.*

As well, the Court found that nothing indicated that at the time these amounts were transferred that the affiliates intended this to be a credit line transfer. As the Court notes:

> *There is simply no evidence that Merco and its affiliates, when booking these transactions, intended to create loans to or from petitioner. Mr. Carreras' adjustments to a notional line of credit, uniformly made after the close of each relevant tax year, do not suffice to create indebtedness to petitioner where none in fact existed. See Delta Plastics v. Commissioner, 54 T.C. 1287, 1291 (1970) (disregarding promissory note that did not reflect an "intent by both parties, substantially contemporaneous to the time of such transfer, to establish an enforceable obligation of repayment"); Parson v. Commissioner, T.C. Memo. 1974-183, 33 T.C.M. (CCH) 789 (finding no indebtedness to common shareholder of multiple S corporations, which had loaned each other money, until such time as the shareholder himself repaid the advances), aff'd without published opinion, 554 F.2d 1070 (9th Cir. 1977).*

The Court had also noted that Mr. Meruelo was not economically worse off following the purported "loan" from him to Merco than he was immediately before the transfer—rather, the risk of loss was borne by the affiliated corporation, a separate entity.

But Mr. Meruelo argued that this was no longer relevant, citing the 2014 regulations that, per the preamble, were meant to replace the "poorer in a material sense" test with a "bona fide debt" test that was to be based on general Federal tax principals. But the Tax Court noted that those "general Federal tax principals" the reality of an actual economic outlay had always been considered.

The Court noted:

> *The test set forth in the new regulation — limiting basis to "bona fide indebtedness of the S corporation that runs directly to the shareholder" — is the same test set forth in prior case law. See, e.g., Hitchins, 103 T.C. at 715 ("[T]he indebtedness of the S corporation must run directly to the shareholders[.]"); Prashker v. Commissioner, 59 T.C. 172, 176 (1972) ("Clearly there must be a debt running directly to the shareholder in order to permit the deduction * * * of a corporate net operating loss.").*
>
> *Moreover, the new regulation provides that the existence of bona fide indebtedness shall be determined "under general Federal tax principles." The "actual economic outlay" doctrine is a general tax principle that this Court has applied, in cases too numerous to mention, to determine whether a shareholder has*

> *made a bona fide loan that gives rise to an actual investment in the corporation. See, e.g., Hitchins, 103 T.C. at 715; Ruckriegel v. Commissioner, T.C. Memo. 2006-78, 91 T.C.M. (CCH) 1035, 1040; Oren v. Commissioner, T.C. Memo. 2002-172, 84 T.C.M. (CCH) 50, 57, aff'd, 357 F.3d 854 (8th Cir. 2004). And principles developed in other tax contexts, requiring that a corporation's indebtedness to a shareholder be genuine and reflect economic reality, apply with equal force for purposes of section 1366(d)(1). See, e.g., Geftman v. Commissioner, 154 F.3d 61, [*12] 73 (3d Cir. 1998) (requiring "objective indicia of an obligation" to support the existence of indebtedness between related parties), rev'g in part, vacating in part T.C. Memo. 1996-447.*
>
> *… Requiring that the shareholder have made an "actual economic outlay" is a general tax principle that may be employed under the new regulation, as it was applied under prior case law, to determine whether this test has been met.*

The result in this case was that the taxpayer was denied $8,051,826 of loss from Merco when the complex was repossessed by the bank in 2008. The loss in question was very real—Mr. Meruelo simply didn't have any remaining basis against which to claim the loss.

In the end this case was just like many other before it—a shareholder cannot obtain basis in an S corporation debt when a related entity, rather than the shareholder him/herself, makes the loan. Unfortunately, getting clients to stop making such transfers and instead place funds into the loss corporation themselves from their own accounts (even if they take eventually have to take distributions from the related entities to replenish their accounts) is often difficult.

However, the accountant here, like the one you can read about in the *Ruckriegel*[2] case noted above, appears to have given up on changing the client's behavior, and rather attempted to paper over the problem when the tax return was prepared. And, unfortunately, the result in this case was the same as in *Ruckriegel*—a very real economic loss could not be taken as a deduction.

Section: 6701
Engineer is Potentially Subject to Penalty for Overly Aggressive Cost Segregation Study

Citation: Chief Counsel Advice 201805001, 2/2/18

In a Chief Counsel Memorandum (CCA 201805001), the IRS found that a "tax-consultant engineer" could be held liable for a penalty under IRC §6701 for aiding and abetting another person in the understatement of that person's tax liability. In the matter at hand, the engineer had advised the taxpayer to, at least in the IRS's view, overly aggressively attempt to reclassify portions of a building to have their costs recovered under much shorter lives.

IRC §6701(a) provides in part:

> *(a) Imposition of penalty*
>
> *Any person—*
>
> > *(1) who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document,*

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[2] *Ruckriegel v. Commissioner,* T.C. Memo. 2006-78

> *(2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and*
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> *(3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person,*
>
> *shall pay a penalty with respect to each such document…*

In this situation, the IRS asserted the engineer had gone well beyond the bounds of what was justified in taking portions of the cost of the building out of a 39-year life into much shorter lives. As the memo notes:

> *The IRS determined that the S incorrectly reclassifies property in order to accelerate or "front-load" depreciation deductions during the first 5 years the property is placed in service, thereby creating larger tax losses for P's clients. The IRS considers the portions of the S categorizing certain structural components as 5-year property to be the most egregious misrepresentations concerning the classification of property for tax purposes. You requested our views on whether P is liable for a $1,000 penalty for each taxpayer's return upon which an excessive depreciation deduction was claimed as a consequence of following the conclusions in the S.*

For purposes of this analysis, accepting that finding as correct, the question arises regarding whether such conduct would subject the engineer to a potential penalty under IRC §6701 and how many such penalties the engineer might owe.

The memo concludes that this sort of work (that is, a cost segregation study) is subject to the penalties found in IRC §6701 should the engineer advance an unjustifiably aggressive position.

As the memorandum concludes:

> *The written S satisfy the elements of a section 6701 penalty. P prepared and furnished to each of his clients a detailed S. Consequently, the S fall within the requirements of section 6701(a)(1). The S also meet the criteria of section 6701(a)(2) and (3); P knew that they would be used in connection with the preparation of individual and corporate tax returns. Thus, P knew or had reason to believe that his clients, both individual and corporate taxpayers, would use the S as guidance in claiming depreciation deductions on returns, a material matter under the internal revenue laws, and that the S would (if so used) result in understatements of tax liability of other persons. Thus, each S is a document that supports a penalty in an amount determined under section 6701(b). To the extent the S related to the tax liability of a corporation, the penalty amount is $10,000 per S furnished. For S furnished to taxpayers other than corporations, the penalty equals $1,000 per S furnished. I.R.C. § 6701(b)(1).*

As well, the penalty would apply to each year the study was made use of to reduce the taxpayer's tax liability. The memo goes on:

> *Each of P's clients had to file a Form 1040 or 1120 with the IRS in order to claim a deduction for depreciation. P aided or assisted in the preparation of each individual or corporate tax return upon which a client claimed a depreciation deduction in an incorrect amount by virtue of misclassifying personal or real property in accordance with the S. The purpose behind P's review, analysis and classification of a client's articles of property was to assist his client in preparing and filing a tax return that included a depreciation deduction exceeding the allowable amount under the Code and thereby understating taxable income. By furnishing a S to a client that classified certain real property as personal property, with purported useful life of only 5 years, P aided or assisted his clients in the preparation of incorrect returns for 5 different tax periods. As a result, he is liable for one penalty for*

each of the years for which a return was filed with the IRS claiming an excessive deduction for depreciation. In regard to P's individual clients, the penalty on P would be $5,000 ($1,000 for each of the 5 understatements reflected in 5 separate tax returns) and for corporate clients the penalty is $10,000 per return.