# Current Federal Tax Developments

Week of May 14, 2018

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF MAY 14, 2018
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# Current Federal Tax Developments

Kaplan Professional Education

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## Section: 108
## Savings Account Held by Son as Nominee, Must Be Counted in Calculation of Solvency for Debt Discharge Exclusion

### Citation: Hamilton v. Commissioner, TC Memo 2018-62, 5/8/18

In the case of *Hamilton v. Commissioner*, TC Memo 2018-62, the taxpayer had excluded from income cancellation of indebtedness of $158,511. The taxpayers claimed they qualified for the insolvency exclusion under IRC §108(a)(1)(B), with liabilities in excess of assets at the time of the discharge of $165,871. But the IRS objected that they had omitted from their calculation of insolvency a significant asset—a savings account held by their son that had been funded by the taxpayers and which the taxpayers regularly used to pay personal expenses.

Under IRC §61(a)(12), a discharge of indebtedness is specifically called out as a type of gross income subject to tax. However, IRC §108 provides that, in a number of specific circumstances, a taxpayer is able to exclude from income some or all of the discharge.

The provision in question here, IRC §108(a)(1)(B) allows for the exclusion from income a discharge that occurs "when the taxpayer is insolvent." The fact that an asset may be impervious to the claims of creditors does not exclude it from consideration (see *Carlson v. Commissioner*, 116 TC 87 (2001)).

The Court begins the description of the fact in this case by describing how the debts in question came to arise and the situation that caused the discharge:

> *Petitioners have an adult son, Andrew Hamilton (Andrew). Petitioner husband (Mr. Hamilton) obtained student loans to finance Andrew's education. In 2008 Mr. Hamilton injured his back, was diagnosed with degenerative disc disease, and became permanently disabled as a result of his injuries. In June 2010 he sought to have the loans discharged because of his disability. In 2011 (year in issue) Nelnet and the Missouri Higher Education Loan Authority (MOHELA) discharged $157,199 and $1,312, respectively, of Mr. Hamilton's debt. Also in 2011 Mr. Hamilton received a $308,105 nontaxable cash distribution relating to his 14.4% interest in a limited liability company.*

Around the same time, Mr. Hamilton began engaging in what the opinion described as "erratic" spending behavior, at which point Mrs. Hamilton took over managing the finances. Presumably to "wall off" Mr. Hamilton's ability to access funds to continue his erratic spending behavior, the taxpayers took the following actions:

> *On April 1, 2011, petitioners transferred $323,000 to Andrew's Chase bank savings account. Andrew gave Mrs. Hamilton his electronic banking username and password and gave her permission to transfer funds from his savings account. Throughout 2011 Mrs. Hamilton regularly transferred money from Andrew's savings account to the petitioners' joint account, from which she paid a majority of the household bills.*

In the calculation of the taxpayers' solvency status, their CPA did not include this savings account (which was owned by their son) but did include all other assets and liabilities of the taxpayers. The IRS did not dispute any of the values of the assets or liabilities included in that calculation.

The parties stipulated that if, in fact, the Chase savings account of their son was an asset of the taxpayers they would be solvent (and thus all discharge income would be taxable). As well, if

that account was not properly includable in the calculation of solvency, the taxpayers were insolvent and would qualify for a full exclusion of the discharge income.

The IRS contention is simple—Andrew was holding the savings account, nominally in his name, solely as a nominee for his parents.

Ownership of assets is a state law question, as states control the definition of property rights generally in the United States. In this case the state in question is Utah. The Tax Court, citing the case of *United States v. Wade* (No. 2:15CV00883 DS, 2017 U.S. Dist. LEXIS 163345, at *20-*21 (D. Utah Oct. 2, 2017), found that under Utah law there are six factors that must be considered to determine if a nominee relationship exists:

- The taxpayer exercises dominion and control over the property while the property is in the nominee's name;
- The nominee paid little or no consideration for the property;
- The taxpayer placed the property in the nominee's name in anticipation of a liability or lawsuit;
- A close relationship exists between the taxpayer and the nominee;
- The taxpayer continues to enjoy the benefits of the property while it is in the nominee's name; and
- The conveyance to the nominee is not recorded.

In this case, the Court found that Andrew did hold this account as nominee for his parents, stating:

> *The parties' stipulations reflect that although the transferred funds were placed in Andrew's savings account, Mrs. Hamilton was able to freely transfer funds to petitioners' joint account to pay household bills (i.e., she exercised dominion and control). There is no evidence that Andrew paid any consideration for the funds transferred to his savings account, or that the funds were transferred in anticipation of a lawsuit or a liability. There is, however, sufficient evidence to establish that a close relationship existed between petitioners and their son Andrew, and that petitioners continued to enjoy the benefits of the funds they transferred to Andrew's savings account. In short, petitioners have failed to establish that Andrew was not their nominee. See Rule 142(a). We accordingly find that during the year in issue petitioners' assets exceeded their liabilities by at least $60,002, and thus their $158,511 of canceled debt should be included in income. See secs. 61(a)(12), 108(d)(3).*

A key issue to note about this case is that it involved both the tax law and issues that were governed by law outside the tax law. Those who are not licensed members of the Bar need to be aware of the limits of their expertise and licensing in such matters—the only real dispute turned on an interpretation of Utah property law, not the Internal Revenue Code. For such issues, consideration needs to be given to consultation with competent counsel with expertise in the appropriate areas.

## Section: 223
## HSA Inflation Adjusted Limits for 2019 Released

### Citation: Revenue Procedure 2018-30, 5/10/18

In Revenue Procedure 2018-30 the IRS provided updated numbers for 2019 for health savings accounts and the related high deductible health plans.

The annual contribution limits for 2019 for health savings accounts under IRC §223(b)(2)(A) will be:

- Self-only coverage: $3,500
- Family coverage: $7,000

The minimum deductible for a high deductible health plan under IRC §223(c)(2)(A) for 2019 will be:

- Self-only coverage: $1,350
- Family coverage: $2,700

The maximum out of pocket expenses, including deductible, co-payments and other items *except* premiums for a high deductible health plan for 2019 may not exceed:

- Self-only coverage: $6,750
- Family coverage: $13,500

## Section: 382
## IRS Modifies Safe Harbor RBIG and RBIL Calculations for Section 382 Due to TCJA Changes to Bonus Depreciation

### Citation: Notice 2018-30, 5/8/18

In Notice 2018-30 the IRS has modified certain safe harbor calculations for recognized built in gain (RBIG) and recognized built in loss (RBIL) as it relates to limitations under IRC §382. The IRS has revised guidance found in Notice 2003-65 to modify the safe harbor rules found in the IRC §§338 and 1374 approaches described in that ruling.

IRC §382 serves to limit the ability to "buy losses" in an existing corporation, limiting the corporation's ability to claim pre-ownership change losses against post-change taxable income. That ability is limited by the §382(b) limitation for each taxable year.

The corporation may have assets worth less than their book value at the time of the ownership change. The notice describes the treatment of such losses as follows:

> *Section 382(h) provides rules for the treatment of built-in gain or loss with respect to assets owned by the loss corporation at the time of its ownership change. Under that provision, if, at the time of an ownership change, a loss corporation has a net unrealized built-in gain (NUBIG), any RBIG for a taxable year within the 5-year recognition period following the ownership change increases the section 382 limitation for that year, but not above the amount of the NUBIG. Similarly, if a loss corporation has a net unrealized built-in loss (NUBIL), any RBIL for a taxable year within the 5-year*

> *recognition period is a pre-change loss subject to the section 382 limitation, but not above the amount of the NUBIL.*

The IRS provided in Notice 2003-65 two safe harbor methods that could be used by a taxpayer to recognize that built in gain and/or built in loss over the years in question. Generally, the rule looks to provide a deemed recognized gain in a year equal to the additional depreciation that could have been claimed if that built-in gain was actually part of the basis of the asset. It also provides a similar calculation to take into the excess depreciation that is being claimed on assets with a fair value that is less than their basis at the time of the ownership change.

As the new Notice states:

> *Under the 338 approach, items of RBIG and RBIL are identified—*
>
> > *…generally by comparing the loss corporation's actual items of income, gain, deduction, and loss with those that would have resulted if a section 338 election had been made with respect to a hypothetical purchase of all of the outstanding stock of the loss corporation on the change date…*
>
> *Notice 2003-65, 2003-2 C.B. at 749. As described in Section IV of Notice 2003-65, under the 338 approach, certain assets generate RBIG or RBIL even if not disposed of during the recognition period. Specifically, the 338 approach treats as RBIG or RBIL (as the case may be) the difference between the loss corporation's actual allowable cost recovery deduction with respect to an asset and the hypothetical cost recovery deduction that would have been allowable with respect to the asset had an election under section 338 been made for a purchase of the loss corporation's stock.*

The Recognized Built-In Gain for a year under the 338 approach is, per the Notice, determined as follows:

> The 338 approach assumes that, for any taxable year, an asset that had a built-in gain on the change date generates income equal to the cost recovery deduction that would have been allowed for such asset under the applicable Code section if an election under section 338 had been made with respect to the hypothetical purchase. Therefore, with respect to an asset that had a built-in gain on the change date, the 338 approach treats as RBIG an amount equal to the excess of the cost recovery deduction that would have been allowable with respect to such asset had an election under section 338 been made for the hypothetical purchase over the loss corporation's actual allowable cost recovery deduction.

A similar approach is used to compute the recognized built-in loss, determining the "excess" depreciation being claimed by the entity.

All was well until the Tax Cuts and Jobs Act, which expanded IRC §168(k)'s bonus depreciation, now set at 100%, to apply to used property—which would include property that would be part of a §338 election. Thus, the calculations specified under the above methods would end up generating very different numbers than occurred prior to TCJA.

The IRS has decided to change the method to eliminate the use of bonus depreciation in these hypothetical calculations. As the IRS notes:

> *…[T]he Treasury Department and the IRS have determined that the hypothetical cost recovery deduction using the additional first year depreciation allowed under section 168(k) does not provide a reasonable estimate of the income or expense produced by a built-in gain or loss asset during the*

> *recognition period. Thus, the use of this additional first year depreciation would invalidate the assumption that underlies the section 338 approach, as set forth above.*

The IRS notes that the problem also spills over to a portion of the alternative safe harbor §1374 approach described in the 2003 notice.

> *The 1374 approach generally incorporates the rules of section 1374(d) of the Code and §§ 1.1374-3, 1.1374-4, and 1.1374-7 of the Income Tax Regulations in identifying RBIG and RBIL. The 1374 approach relies on the accrual method of accounting in determining whether certain items of income or deduction are RBIG or RBIL respectively. However, in accordance with section 382(h)(2)(B), the 1374 approach treats any allowable deduction for depreciation, amortization, or depletion (collectively, "amortization") of a built-in loss asset as RBIL, except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset's adjusted basis over its fair market value on the change date, regardless of whether the amount accrued for tax purposes before the change date. In determining the amount of amortization deduction that is not attributable to an asset's built-in loss on the change date, Notice 2003-65 provides:*
>
> > *One acceptable method is to compare the amount of the amortization deduction actually allowed to the amount of such deduction that would have been allowed had the loss corporation purchased the asset for its fair market value on the change date. The amount by which the amount of the actual amortization deduction does not exceed the amount of the hypothetical amortization deduction is not RBIL.*
>
> *Notice 2003-65, 2003-2 C.B. at 749. This method is essentially the same as the 338 approach for determining RBIL.*

Thus, the IRS again rules that the bonus depreciation provisions of IRC §168(k) are not to be used for this approach either.

The notice is effective for ownership changes occurring after May 8, 2018.

## Section: 446
## Automatic Change Revenue Procedure Released for Accounting Method Changes Related to Adoption of ASC 606

### Citation: Revenue Procedure 2018-29, 5/10/18

The same week as the IRS released the annual revised general purpose automatic method change list revenue procedure the agency decided to release the revenue procedure outlining how taxpayers may request a change of accounting method related to the GAAP changes taking place under ASC 606, *Revenue from Contracts with Customers.* The change procedures are contained in Revenue Procedure 2018-29.

While this procedure is generally good news, it most clearly does *not* mean that the IRS is going allow the use of methods provided under ASC 606 without regard to whether the method is otherwise allowable under the IRC. The taxpayer will have to make its own determination regarding whether or not conforming tax and book methods in their situation is actually allowed under the IRC.

In the second paragraph of the procedure the IRS notes that this procedure does *not* deal with the other major GAAP/tax accounting method issue for 2018 found in the new revenue

conformity provision at IRC §451(b) and (c) added by the Tax Cuts and Jobs Act, noting the agency is working on additional guidance to deal with that issue.

The Financial Accounting Standards Board (FASB) issued the reboot of revenue recognition rules for U.S. GAAP (ASU 2014-09) at the same time the International Accounting Standards Board (ISB) issued the identical IFRS 15. ASC 606 takes effect for:

- Annual reporting periods beginning after December 15, 2017 for publicly traded-entities along with certain not-for-profit entities and certain employee benefit plans *and*
- Annual reporting periods beginning after December 15, 2018 for all other entities.

The IRS Revenue Procedure summarizes the new revenue reporting standard issued by FASB as follows:

> *Under the New Standards, an entity will recognize revenue for promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services based on the following five sequential steps: (i) identify the contracts with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations; and (v) recognize revenue as the entity satisfies a performance obligation.*

The IRS had issued Notice 2017-17 asking for comments on dealing with this change and what accounting change options would be desirable and possible. The IRS notes that commenters indicated there would be significant impact for taxpayers "in the technology and construction industries and service providers with warranty and repair service contracts."

In response to comments received, the IRS indicates the agency made the following adjustments in the final guidance found in this revenue procedure:

> *Specifically, this revenue procedure creates new automatic accounting method change procedures, applies rules similar to the small business exception in the proposed revenue procedure in Notice 2017-17 to more taxpayers, and provides taxpayers the option of implementing the accounting method change on either a cut-off basis or with a § 481(a) adjustment.*

A new Section 16.11 is added to the list of automatic accounting method changes that was published the day before in Revenue Procedure 2018-31[1], titled "Changes in the timing of recognition of income due to the New Standards."[2]

The new automatic method change lists the following in its applicability section at 16.11(2):

> *This change applies to a taxpayer that wants to change its method of accounting for the recognition of income for federal income tax purposes to a method under the New Standards for: (i) identifying performance obligations, (ii) allocating transaction price to performance obligations, and/or (iii)*

---

[1] No, it's not a typo on the revenue procedure number. The general procedure, despite being published a day earlier actually has a higher number than this specific procedure.

[2] Revenue Procedure 2018-29, Section 3.01

> *considering performance obligations satisfied. A taxpayer may request a change under this section 16.11 only if the taxpayer's new method of accounting is otherwise permissible for federal income tax purposes and the change in method of accounting is made for the taxable year in which the taxpayer adopts the New Standards for financial accounting purposes. A taxpayer's allocation of transaction price to performance obligations to comply with the New Standards under this section 16.11 is deemed to be an allocation based on objective criteria. See section 5.02(4)(c) of Rev. Proc. 2004-34, 2004-1 C.B. 991, as modified and clarified by Rev. Proc. 2011-18, 2011-5 I.R.B. 443, and Rev. Proc. 2013-29, 2013-33 I.R.B. 141, and as modified by Rev. Proc. 2011-14, 2011-4 I.R.B. 330.*

However, the procedure does outline situations for which this procedure cannot be used at Section 16.11(3):

> *This change does not apply to:*
>
> > *(a) a change in the manner in which the taxpayer identifies contracts or determines the transaction price, including the inclusion and exclusion of variable consideration in the transaction price, under the New Standards;*
> >
> > *(b) a change in method of accounting for recognizing income that is made in a year that is different from the year that the taxpayer adopts the New Standards;*
> >
> > *(c) a change in method of accounting that does not comply with §451 or other guidance;*
> >
> > *(d) any change in method of accounting that qualifies under another automatic change described in the List of Automatic Changes provided in this revenue procedure (or any successor), even if it is described in section 16.11(2) of this revenue procedure, and otherwise satisfies the requirements of paragraphs 5.01(1)(a)-(d) of Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (or any successor). The taxpayer must request such change(s) in method of accounting by applying the automatic change procedures in Section 6 of Rev. Proc. 2015-13 (or any successor) and the respective section of Rev. Proc. 2017-30 (or any successor); or*
> >
> > *(e) any change in the method of accounting for income from a long-term contract, as defined in §460(f), unless the long-term contract is excepted from required use of the percentage-of-completion method by §460(e)(1).*

The IRS is going to grant taxpayers three years in which to decide if they wish to request a qualifying automatic change. Section 16.11(04) provides "[t]he change under this section 16.11 may only be made in the taxpayer's first, second, or third taxable year ending on or after May 10, 2018."

The revenue procedure gives all taxpayers the option of implementing the change on either the cut-off basis or by using the standard §481(a) adjustment periods (normally 4 years for a positive change and 1 year for a negative one). The notice goes on to provide the following rules for a taxpayer wishing to use the cut-off method:

> *If the taxpayer implements the change on a cut-off basis, (i) the taxpayer must allocate any payment allocations prior to the year of change using the taxpayer's former method of accounting, (ii) all changes made under this section 16.11 must be implemented using a cut-off basis, and (iii) a § 481(a) adjustment is neither permitted nor required.*

As well, the use of a cut-off method is mandated for all intercompany transactions for members of a consolidated group, avoiding a mismatch where the positive adjustment side would be

spread over 4 years with the negative side picked up immediately. The revenue procedure provides:

> *Notwithstanding anything to the contrary in this section 16.11(5)(a), if a taxpayer is a member of a consolidated group (within the meaning of § 1.1502-1(h)), then the member must implement all changes with respect to its intercompany transactions (within the meaning of § 1.1502-13(b)(1)(i)) under this section 16.11 on a cut-off basis and can apply the first two sentences of this section 16.11(5)(a) to all other transactions. See § 1.1502-17(b)(2); section 7.02 of Rev. Proc. 2015-13.*

The application will be available using simplified Form 3115 filing requirements. Section 16.11(5)(b) provides:

> *A taxpayer making a change under this section 16.11 is required to complete only the following information on Form 3115 (Rev. December 2015):*
>
> > *(i) The identification section of page 1 (above Part I);*
> >
> > *(ii) The signature section at the bottom of page 1;*
> >
> > *(iii) Part I;*
> >
> > *(iv) Part II, all lines except lines 13,16c, and 19; and*
> >
> > *(v) Part IV, all lines. For a taxpayer making a change under this section 16.11 using a §481(a) adjustment, the statement required for Line 26 of Form 3115 should list a description of each change, the §481(a) adjustment for each change (or a statement that the change is being made on a cut-off basis) and, if applicable, a description of where the item's §481(a) adjustment is reflected on the federal income tax return (line number (or schedule)).*
>
> *In addition, the requirement to file the duplicate copy, under section 6.03(1)(a) of Rev. Proc. 2015-13, is waived.*

This method will not allow taxpayers to change to a method of accounting that otherwise is at odds with the requirements of any provisions of the IRC, as Section 16.11(3)(c) noted. Because of this, the IRS notes that there is no ruling on the acceptability of the actual method used when the request to change methods under this Revenue Procedure is made.

As Section 16.11(7) provides:

> *The consent granted under section 9 of Rev. Proc. 2015-13 for a change made under this section 16.11 is not a determination by the Commissioner that the new method of accounting is a permissible method of accounting and does not create any presumption that the allocation method is a permissible method of accounting under any provision of the Code. Further, the consent granted under section 9 of Rev. Proc. 2015-13 for a change made under this section 16.11 is not a determination that the amount of income included in taxable income using an allocation method described in the New Standards is correct. The Director will ascertain whether the new method of accounting is a permissible method of accounting and whether the allocation method is permissible under the Code (for example, a method that is permitted under § 451).*

Section 16.11(8) does allow a taxpayer to file a single Form 3115 to obtain permission to make multiple method changes under this procedure, but if a §481(a) adjustment is used the amount of the §481(a) adjustment must be disclosed for each change and the taxpayer may not net the positive and negative adjustments to come up with a single §481(a) adjustment.

The designated change number (DCN) for this change is 231—that number is to be provided in the appropriate location on the Form 3115.

This is not necessarily the end of the guidance on ASC 606's interaction with tax accounting methods—the IRS continues to ask for comments on the following issues related to ASC 606:

> *1. What additional change in accounting method requests do taxpayers anticipate requesting due to the New Standards?*
>
> *2. What additional procedural guidance might be helpful as a result of the New Standards?*
>
> *3. What industry-specific guidance might be helpful as a result of the New Standards?*

A large portion of taxpayers that are looking at the issue of accounting method changes to reduce book/tax differences following the adoption of ASC 606 likely have "applicable financial statements" as defined in IRC §451(b)(3). Such a statement is the first of the following financial statements a taxpayer may have produced for a tax year:

> *(A) a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is—*
>
> > *(i) a 10–K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the United States Securities and Exchange Commission,*
> >
> > *(ii) an audited financial statement of the taxpayer which is used for—*
> >
> > > *(I) credit purposes,*
> > >
> > > *(II) reporting to shareholders, partners, or other proprietors, or to beneficiaries, or*
> > >
> > > *(III) any other substantial nontax purpose,*
> >
> > *but only if there is no statement of the taxpayer described in clause (i), or*
> >
> > *(iii) filed by the taxpayer with any other Federal agency for purposes other than Federal tax purposes, but only if there is no statement of the taxpayer described in clause (i) or (ii),*
>
> *(B) a financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government which is equivalent to the United States Securities and Exchange Commission and which has reporting standards not less stringent than the standards required by such Commission, but only if there is no statement of the taxpayer described in subparagraph (A), or*
>
> *(C) a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary, but only if there is no statement of the taxpayer described in subparagraph (A) or (B).*

IRC §451(b)(1), as added to the IRC by the Tax Cuts and Jobs Act, requires a taxpayer with such an applicable financial statement who is reporting on the accrual basis of accounting for tax purposes to treat the "all events test" of IRC §451 to be met no later than when such revenue is taken into account for such an applicable financial statement or any other statement produced by the taxpayer that the IRS specifies will count for these purposes.

As well, IRC §451(c) provides an election for a taxpayer to use the special advance payment method of accounting that was previously allowed under a separate revenue procedure.

The IRS is asking for comments on guidance to be issued for these §451(b) and (c) changes. Specifically, the agency is asking:

> *1. What change in method of accounting requests do taxpayers anticipate filing due to the interplay of the New Standards with amended § 451(b) or (c)?*
>
> *2. As taxpayers transition to amended § 451, what procedural guidance might be helpful?*
>
> *3. As taxpayers transition to amended § 451, what industry-specific guidance might be helpful?*

## Section: 446
## 2018 Revision of Comprehensive List of Automatic Changes Released with a Promise TCJA Method Change Procedure to Come Later

### Citation: Revenue Procedure 2018-31, 5/9/18

The IRS has updated the long (now 333 pages) document listing all of the automatic accounting method changes in Revenue Procedure 2018-31. This is the document that outlines the changes that can be made by attaching a Form 3115, *Application for Change in Accounting Method*, to the taxpayer's tax return for the year of change (along with a copy to the IRS processing center in Covington, KY) rather than going through the process of applying for approval of the change and awaiting the IRS's decision.

If you were hoping to see automatic change procedures outlined for changes added by the Tax Cuts and Jobs Act (TCJA), those are not in this document. There were a few changes made to prior automatic changes (such as those impacting IRC §263A) to get ready for the new small business changes, but none of the small business changes, nor the revenue conformity change required for some businesses by IRC §451(b) as revised by TCJA are found in this document.

The IRS in the Notice does address the small business accounting rule by indicating that a later Revenue Procedure will take care of those changes:

> *Because of the amendments made to §§ 263A, 448, and 471 by § 13102 of Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017) (the "Act"), the Department of the Treasury and the Internal Revenue Service expect to issue a revenue procedure providing procedures for making changes implementing § 13102 of the Act.*

Presumably the IRS will also address the changes that will be required under IRC §451(b) for entities with an applicable financial statement in a similar revenue procedure.

The IRS provides a list of significant changes beginning on page 324 of the posted document. Most of the changes get rid of obsolete method changes in addition to preparing for the small business accounting method changes noted above.

The new Revenue Procedure applies to changes of methods filed on after May 9, 2018 (the date the new procedure was issued) for tax years ending after September 30, 2017. If a taxpayer had previously filed for a non-automatic change of accounting method and the change request was still pending with the National Office on May 9, 2018 and the change is now available as an automatic change, the taxpayer can request that the change now be processed as an automatic change by notifying the National Office by the later of:

- June 8, 2018 *or*

- The issuance of a letter ruling granting or denying the request for change.

A taxpayer who switches to the use of an automatic method under this revenue procedure will be notified by the National Office that the request was received and, probably of interest to the taxpayer, the user fee will be refunded.

If the taxpayer faces the opposite problem—that is, what was available as an automatic method under the prior revenue procedure is no longer available—a different set of transition rules apply. If the application was filed by the taxpayer before May 9, 2018, then the taxpayer can proceed with the change in method under the prior automatic change option. If, however, the request has not yet been filed (that is, the return had not been filed before May 9, 2018) then a taxpayer who wishes to move forward with a change in method must convert to the non-automatic change methods. The due date for the Form 3115 for a taxpayer in such a situation is subject to a special relief provision. For the last tax year ending before May 9, 2018 the due date for the Form 3115 is now required to be filed on or before the due date of the taxpayer's return of the year in question. As well, that date will be set to the extended due date for that return even if the taxpayer did not file for an extension of time to file the return.

As the new list is effective immediately, any professional that has a change of accounting method request in process for a not-yet-filed tax return should consult this list to determine what changes, if any, will affect the request for change of accounting method for the impacted taxpayer(s).

## Section: 1221
## Taxpayer Had No Asset to Sell, Income Was Ordinary

### Citation: Pexa v. United States, Case No. 2:16-cv-00994, U.S. District Court, Eastern District of California, 5/7/18

In the case of *Pexa v. United States*, Case No. 2:16-cv-00994, U.S. District Court, Eastern District of California the taxpayer was attempting to defend his treatment of termination payments for his termination payments received from Farmers Insurance as long term capital gain income. The District Court had this matter before it on appeal from the Bankruptcy Court, which had ruled against the taxpayer.

Mr. Pexa had been involved first as an insurance agent and, eventually, a district manager for Farmers Insurance. When he was promoted to district manager he was no longer allowed to sell insurance, rather now being in charge of recruiting, training, and supervising agents. As such, he sold his agency to his sister in 1998, with a note payable over 20 years.

Mr. Pexa reported the interest on the note as ordinary income and the principal as capital gain from the sale of intangible asset. Mr. Pexa indicated he had been audited by the IRS on several occasions, and this treatment was not questioned nor were any other major issues raised.

Eventually Mr. Pexa and Farmers parted ways. As the opinion describes the matter:

> *In early 2009, Pexa was unhappy with his relationship with Farmers and sent a letter to Farmers discussing his unhappiness with changes in Farmers' practices. (ECF No. 7-11 at 5-6, 19.) This letter was interpreted by Farmers as an invitation by Pexa to terminate his relationship as a district manager. (ECF No. 7-11 at 19.) On January 26, 2009, Farmers issued Pexa a 30 day notice of termination pursuant to paragraph (d) of Pexa's District Manager Appointment Agreement (the*

> *"Agreement"), which provided that the Agreement "may be cancelled without cause by either the District Manager or [Farmers] on 30 day written notice." (ECF Nos. 7-5 at 2; 7-11 at 6.) Pursuant to the Agreement, upon termination, Farmer's was required to pay Pexa the "contract value," an amount determined based on the number of years Pexa worked as a district manager and the commissions he received during the six months immediately preceding his termination. (ECF Nos. 7-5 at 2; 7-11 at 6-7.) In the event that Farmers elected to pay the "contract value," Pexa agreed to "transfer and assign all of his interest under the agency to the nominee acceptable to [Farmers] or to [Farmers]." (ECF No. 7-5 at 3.)*

These contract value payments were reported to Mr. Pexa by Farmers on a Form 1099-MISC as non-employee compensation for the years in question.

Mr. Pexa had his returned prepared by a paid preparer, Mr. Allen. The Court described how the information was provided to Mr. Allen:

> *Pexa did not provide detailed documentation to Mr. Allen for the preparation of the 2009 and 2010 returns. (ECF No. 7-11 at 43.) Mr. Allen simply accepted summary worksheets that included the items of income and deductions that Pexa believed he should claim on his returns. (ECF No. 7-11 at 43.) Mr. Allen took Pexa's word for what his income and expenses were and prepared the returns accordingly. (ECF No. 7-11 at 44.) Mr. Allen was not provided with the 1099 forms, nor was he provided with the Agreement. (ECF No. 7-11 at 44.)*

Mr. Allen attempted to determine the proper way to report the amounts received even though he did not have the underlying agreements. Based on what Mr. Pexa told him, he did the following:

> *Mr. Allen believed that the "contract value" payments Pexa received from Farmers were for work that Pexa performed as an insurance agent, and he was unfamiliar with the term district manager and the responsibilities associated with the position. (ECF No. 7-11 at 21.) Mr. Allen testified that he found the case Johnson v. Commissioner, which discusses "contract value" relating to insurance agents, and he used that case as a basis for classifying the "contract value" payments as capital gains income. (ECF Nos. 7-8 at 13; 7-11 at 21-22.)*
>
> *On Pexa's 2009 and 2010 tax returns, the "contract value" payments were included as gross receipts on his Schedule C. (ECF No. 7-11 at 22.) On both returns, the same amount of the "contract value" payments was then deducted by being listed under "other expenses" of the relevant Schedule C. (ECF No. 7-11 at 22.) For the 2009 tax year, a portion of the "contract value" payments was reported as capital gains. (ECF No. 7-11 at 22.) For the 2010 tax year, none of the "contract value" payments were reported as capital gains. (ECF No. 7-11 at 22.)*

The issue before the Court was whether the income from the contract value proceeds should be treated as a capital gain. To be taxed as a long term capital gain, the payments had to arise from the sale or exchange of a capital asset. The opinion notes that a key precondition to being able to sell a capital asset is owning the capital asset purported to be sold.

The taxpayer argued that his insurance agency was the capital asset that was sold to Farmers, essentially arguing that he had a sale of goodwill. But the Court found that he actually never owned the goodwill.

The opinion pointed out that in 2003, the Seventh Circuit had ruled on these termination payments, finding that, based on the terms of the agreement with the insurance company, the agent did not own an asset that could be sold:

> *The Seventh Circuit addressed this exact issue in Baker. 338 F.3d at 793. In Baker, the insurance agent sought to have his termination payments treated as long-term capital gains and argued the payments were in consideration of goodwill. Id. However, the court held that because the agent's contract contained a blanket reservation of property rights to the insurance company, the agent did not "own any assets related to the business," and could not transfer goodwill "apart from the business with which it was connected." Id. at 793-94. The Ninth Circuit adopted Baker's reasoning in Trantina, holding that because the express terms of the agent's agreement contained a blanket reservation of all property rights to the insurance company, the agent "simply had no property that could be sold or exchanged." 512 F.3d at 573.*

The opinion notes that Mr. Pexa's contract with Farmers contained the very same restrictions as found in *Baker* and *Trantina*. As the Court concluded in finding the income was not from the sale of a capital asset:

> *The only "interest under the agency" that Pexa retained was a contractual right to perform services for Farmers and receive compensation for those services as long as the Agreement remained in effect. However, a contractual right to perform services is not a capital asset. Trantina, 512 F.3d at 571-72 ("[T]he courts have quite uniformly held that contracts for the performance of personal services are not capital assets and that the proceeds from their transfer or termination will not be accorded capital gains treatment but will be considered to be ordinary income."). Therefore, because Pexa owned no capital asset, he could not sell or exchange a capital asset. Accordingly, the "contract value" payments that Pexa received are ordinary income, not long term capital gains.*

The Court also sustained the Bankruptcy Court's holding that Mr. Pexa was subject to the accuracy related penalty under IRC §6662 on this understatement. Mr. Pexa argued first that he had relied on the expertise of his preparer, but the opinion rejected that view:

> *There is no dispute that Pexa did not provide Mr. Allen with the material information necessary to make an appropriate determination of whether the "contract value" payments were long term capital gain. Namely, Pexa did not provide Mr. Allen with the Agreement — the single most important document in this determination and the document that dictated the payments Pexa would receive. Therefore, the evidence supports a finding that Pexa could not have reasonably relied on Mr. Allen. See 26 C.F.R. § 1.6664-4(c)(i) ("The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances.")*

The Court also rejected the claim that he had acted reasonably since the IRS, in various prior audits, had never objected to treating the payments from his sister for the earlier sale of the agent business as long-term capital gain income:

> *However, the fact that Pexa classified payments arising out of one transaction as long term capital gains does not necessarily have bearing on whether or not Pexa reasonably and in good faith classified the payments at issue, arising out of a different transaction, as long term capital gains. Moreover, there is no evidence that Pexa classified these prior payments reasonably and in good faith. Therefore, the facts support a finding that Pexa did not make a reasonable and good faith effort to assess his tax liability and could not reasonably and in good faith rely on Mr. Allen or former tax returns in determining whether the "contract value" payments constituted long term capital gains.*